INSURANCE SECTOR TRENDS: FORECAST FOR 2017 AND 2016 YEAR END REVIEW

INTRODUCTION

The insurance industry faced strong headwinds, crosswinds and (a few) favorable tailwinds in 2016. It was a dramatic, unpredictable year, which saw political upheaval, an extremely challenging commercial environment, continuing changes in regulatory standards and increasing friction among regulators and other government actors. Significant developments included:

- Brexit – the reality of which is yet unknown, but the impact of which is already being felt
- The election of Donald Trump as President of the US, which raises profound questions concerning how the US will engage with global markets and the US approach to financial services regulation
- The first full year of Solvency II regulation in Europe
- Mega insurance deals agreed, then thwarted
- A dramatic acceleration in the development, deployment and investment in insurance-oriented technology (InsurTech) by many in the industry and disruptors who seek to transform it
- A historic "covered agreement" between the EU and the US on insurance regulatory accommodation, which may or may not survive the new political realities in the US, but which could help define the relationship between the two largest insurance markets in the world
- Persistent low interest rates/investment yields, continued softening rates for many insurance products and greater competition for customers across almost all sectors of the industry.

Our *Insurance Sector Trends: Forecast for 2017 and 2016 Year End Review* looks at these and other developments from around the world and offers some of our thoughts on how these interrelate and, most importantly, how they may affect your business. We expect 2017 will see the pace of change and the challenges increase. Developments to date suggest this is so.

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INTERNATIONAL DEVELOPMENTS

Brexit Shocker

The insurance industry entered 2016 anticipating an active, but not dramatic year in terms of legal, regulatory and commercial matters. All eyes were on Europe as Solvency II went live on January 1, 2016, and the further work that was expected to be done on international capital standards, systemic risk regulation and other matters. Then came the United Kingdom referendum on June 23, 2016, when Britain voted to exit the European Union. Few saw Brexit coming. It resulted in significant immediate changes, as David Cameron, the British Prime Minister, stepped down, and Lord Jonathan Hill, the influential head of the European Commissions' Financial Stability, Financial Services and Capital Markets Union unit resigned his post (effective July 2016) – which immediately eliminated a pro London voice concerning EU financial services regulations. Theresa May succeeded David Cameron as Prime Minister and immediately announced that "Brexit meant Brexit." In January 2017, Prime Minister May announced a hard-exit – a 12-point plan for a clean break between the UK. At the time of the referendum result, how and when the UK would practically exit the EU was not known. Moreover, the impact to the insurance industry was not immediately understood.

A more detailed discussion of the issues raised by Brexit is found in the European Developments section of this Insurance Forecast, but it is clear that the effects will ripple through all corners of the insurance industry. There are also many unanswered questions. The UK was one of the leading voices in the EU, but it is uncertain what the UK's relationship with the EU will be like going forward, including its role and influence regarding financial services regulation and market access. This uncertainty could extend to the UK's Prudential Regulation Authority's (PRA) influence and role at the IAIS. The PRA currently chairs the Executive Committee of the International Association of Insurance Supervisors (IAIS) and has traditionally been one of its leading voices. This role has always been enhanced because of the UK's role and relationship with EU regulators generally. Similarly, questions arise regarding the UK's commercial and regulatory relationship with the US. Traditionally, the UK and the US have had a very strong regulatory relationship. But over the past few years, this has changed, in the midst of growing tensions between EU and US financial services regulators. Brexit could open the opportunity to reset this relationship – perhaps with benefits to both countries.

International Association of Insurance Supervisors (IAIS)

Key Changes in Leadership

The IAIS is at an inflection point. There are some critical leadership changes at the IAIS, it is at a significant phase of its work on developing an international capital standard for international insurers, and it is, like any organization, reviewing its priorities and goals. The IAIS began 2016 without the services of its Deputy Secretary General, George Brady, who resigned his position at the end of 2015. Then, as anticipated, Secretary General Yoshihiro Kawai announced in the fall that he will step down after 14 years as Secretary General. Many cannot remember a time when Mr. Kawai was not the General Secretary of the IAIS. Additionally, the US Federal Insurance Office (FIO) Director, Michael McRaith, who was a member of the IAIS Executive Committee and Chair of the Technical Committee, stepped down, effective January 20,2017. These changes, and others, have opened up the opportunity, and need, for others to lead and direct the IAIS.

In February 2017, the IAIS named Jonathan Dixon as the successor Secretary-General. Dixon has served as Deputy Executive Officer of the South African financial services regulator, the South African Financial Services Board, since 2008. Dixon also held a number of leadership positions at the IAIS, including serving on the Executive Committee since 2009 and serving as Chair of the Implementation Committee since 2012. Mr. Dixon will become Secretary-General following the IAIS annual conference in Kuala Lumpur, Malaysia in November 2017.

It remains to be seen what the impact of the resignations described above will be on the current initiatives of the IAIS (*i.e.*, Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) and Insurance Capital Standards (ICS), as discussed below). With regard to FIO, its future at the IAIS, and generally, is unclear. Even if the FIO Director will be replaced, it still remains to be seen how US domestic policy will affect the power of the FIO Director and his or her ability to perform on the international stage. Further, it remains to be seen whether the replacement will be dynamic enough to gain entry into the positions of authority within the IAIS.

IAIS Updates

The IAIS continued to expand its agenda and regulatory reach in 2016, but shifted its focus and slowed its pace in certain key areas such as: (i) ComFrame and (ii) consolidated group capital standards for internationally active insurance groups (IAIGs). In addition, for the first time the IAIS sent signals that market regulation is now on its agenda.

International Insurance Capital Standards. Global regulators, led by the Financial Stability Board (FSB) and the IAIS, are continuing work on a capital standard that will apply to global insurers that are determined to be systemically important. In 2016, these activities included continued field testing and, in July 2016, a public consultation with respect to "ICS Version 1.0," which the ICS intends to adopt in 2017.

Nevertheless, the ICS is at a critical crossroads. IAIS members working on the ICS have been dodging key structural issues, such as how internal models may be used in determining capital requirements. There appears to be a lack of a sense of urgency that existed in the aftermath of the 2008 financial crisis that gave rise to the IAIS, ComFrame and ultimately development of the ICS. It does not appear that the members of the IAIS who are working on the technical aspects of ICS have the political buy-in or engagement of the leadership and insurance supervisors of key jurisdictions. Critics point to the fact that unless the ICS has political support that it currently lacks in key jurisdictions (particularly in the US) it will not be worth adopting.

Additionally, various stakeholders are openly criticizing the work that has been done. At a stakeholders session in January 2017, several interested parties unequivocally stated that the current IAIS approach on important issues, such as qualifying capital and valuation methodology, are simply not acceptable. Stakeholders threatened to withdraw from field testing and to initiate new political attacks on the IAIS if material changes to the ICS, as currently proposed, are not made. The National Association of Insurance Commissioners (NAIC) has also been highly critical of a number of the technical positions currently reflected in the ICS, but has been very supportive of positions that have previously been expressed by many US stakeholders, such as how subordinated and senior debt should be treated for purposes of qualifying capital.

ComFrame. ComFrame was first developed in 2010 with most sections completed three years ago when the IAIS started to focus on developing its ICS. There was no effort to work on other parts of ComFrame in 2016. Late in the year, however, the IAIS announced its plans to rewrite the format of ComFrame as it currently exists, departing from the current structure of having three elements, several modules within those elements and parameters and guidelines containing ComFrame's detailed terms and conditions. In its place, ComFrame will be folded into the existing Insurance Core Principles (ICPs). Ostensibly, this is being done in order to clarify the position of ComFrame proponents that ComFrame is based upon the ICPs and logically extends them to IAIGs. Some stakeholders (including some US regulators) are not so sure about that stated intent, expressing concerns that making ComFrame a part of the ICPs will increase the risk that ComFrame will eventually become a Financial Sector Assessment Program (commonly referred to as the FSAP) standard.

The slowed pace, lack of political leadership and engagement and criticisms have led some to predict that the IAIS will not meet its stated goal of adopting the reworked ComFrame, with the ICS in it, at its annual meeting in November 2019. However, on March 3, 2017, the IAIS launched several new consultations related to the so-called "Qualitative" aspects of ComFrame related to topics such as corporate governance, recovery plans, resolution plans and supervisory cooperation, some of which may draw significant criticism from interested parties, but nevertheless, suggest there is a renewed vigor at the IAIS to complete the development of ComFrame as scheduled. 2017 should reveal much as to whether the NAIC and/or industry opposition to the ICS is able to deter the IAIS from keeping to its current time frame for completing the ComFrame and ICS.

Systemically Important Insurers: Developments and the MetLife Legal Challenge

Global Systemically Important Insurers (G-SIIs) Developments

The IAIS announced a revised list of G-SIIs in November 2016, using the methodology from two new consultations issued at the end of 2015. The only changes to the list included removing Generali and adding Aegon. The first consultation was aimed at updating its methodology for identifying G-SIIs by introducing a new "phased approach," intended to provide firms with a greater input and transparency into the G-SII determination process. The objective of this approach is to give firms a better understanding as to why they were designated G-SIIs as well as how firms so designated might remove that designation. Additionally, firms that are not considered to be G-SIIs will also be able to request their scores from the initial stage of the assessment. By 2019, the IAIS plans to publicly disclose more information about how insurers scored against key criteria, provided that such information will not identify particular companies. The second consultation adjusted how supervisors evaluate whether a firm's non-traditional, non-insurance (NTNI) activity presents systemic risk.

The current nine G-SII insurers are: Aegon N.V.; Allianz SE; American International Group, Inc.; Aviva plc; Axa S.A.; MetLife, Inc.; Ping An Insurance (Group) Company of China, Ltd.; Prudential Financial, Inc.; and Prudential plc.

SIFI Designation and the MetLife Judicial Win

It is important to note that FSB's G-SII list is non-binding concerning country-specific designations. In the US, the Financial Stability Oversight Council (FSOC), established under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), is authorized to address systemic risk and has its own process for evaluating and designating domestic systemically important financial institutions (SIFIs), including insurers. The FSOC has designated all three US-based G-SII-listed insurers as systemically important.

In March 2016, the US District Court in Washington, DC rescinded MetLife's designation as a SIFI. As a reminder, MetLife

was designated as a SIFI over the objection of the FSOC's voting insurance expert, Roy Woodall, and the non-voting NAIC member in December 2014. By January 2015, MetLife sued the FSOC in US federal court, seeking to have the designation overturned – alleging that the FSOC relied on "vague standards and assertions, unsubstantiated speculation, and unreasonable assumptions that are inconsistent with historical experience."

The FSOC had been criticized by the insurance industry for a number of reasons,including a lack of transparency in the designation process (*i.e.*, what factors were considered) and the mechanism and metrics by which a company may relieve itself of the SIFI designation. According to the ruling in 2016, the FSOC made an "arbitrary and capricious" decision when it designated MetLife as a SIFI. The court ruled that FSOC failed to follow its own guidelines. FSOC appealed the decision and oral arguments were held in the D.C. Circuit in October 2016. FSOC argued that although Dodd-Frank set forth 10 factors for FSOC to consider in evaluating a company for SIFI status, it does not require the FSOC to assess the likelihood of financial distress, predict the specific effects of a financial bubble collapse on a company, or consider the cost of the SIFI designation. Although the court has not provided an update as of this Insurance Forecast publication date, a decision is still expected in early 2017.

Solvency II: Implementation and Growing Pains

s discussed in further detail in the NAIC and European Development Sections of this Insurance Forecast, Solvency II went live on January 1, 2016. By mid-year, the European Commission began the process to review certain elements of Solvency II, requesting that the European Insurance and Occupational Pensions Authority (EIOPA) review and propose changes to certain technical aspects of Solvency II. EIOPA is currently focused on the Solvency Capital Requirement (SCR) standard formula. While Europe works on its commitment to have a sound, rigorous, evidence-based and transparent process to review Solvency II, the NAIC expressed concerns on the impact of Solvency II on US (re)insurers.

Many jurisdictions are independently reviewing the impact of Solvency II on their insurance industry. The UK House of Commons Treasury Select Committee held hearings regarding the impact of Solvency II on UK (re)insurers, especially in the context of Brexit. At those hearings, heads of various (re)insurers criticized Solvency II directives as damaging the industry by imposing certain requirements that limit investment and require companies to maintain an unreasonably high risk capital element, the added layer of capital that insurers have to hold against long-term business, given the current low interest rate environment.

The NAIC's International Insurance Relations (G) Committee held a hearing during which several US-based insurers described their companies' adverse experiences with Solvency II implementation, including having to confront barriers to doing business in EU countries. Although the NAIC has not yet announced any formal plans to address these concerns, regulators clearly were sympathetic to the concerns of the panelists. In late 2016, members of the Reinsurance Task Force floated the idea that the NAIC may be provoked to change the status of a Qualified Jurisdiction in retaliation if US-based companies continue to be adversely impacted by Solvency II implementation. The Qualified Jurisdiction Working Group is already in the process of studying European jurisdictions, such as Germany, where its physical presence requirement violates the rules governing qualified jurisdictions and could result in the Qualified Jurisdiction's status being placed on probation, suspended or revoked.

The EU-US Covered Agreement

On January 13, 2017, after almost a year of formal negotiations, the US and the EU announced that they had completed negotiation of a "Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance" (Covered Agreement). The Covered Agreement was submitted to Congress on the same day by the US Secretary of the Treasury (Treasury) and the Office of the US Trade Representative (USTR), to begin a statutorily required 90-day review period. The

Implementation

The Covered Agreement covers three substantive areas: reinsurance, group supervision and the confidential exchange of information. The reinsurance and group supervision provisions address issues surrounding freedom of cross border reinsurance transactions from local presence and collateral requirements and recognition of the group supervision sovereignty of both the US and the EU. These two provisions are conditioned upon one another. For example, if one party does not fulfill its obligations with respect to the group supervision provisions, the other party is not obligated to meet the reinsurance obligations and vice versa.

The Covered Agreement uses the terms "Home Party" and "Host Party." Home Party refers to the territory (*i.e*, the US or the EU) in which the worldwide parent of an insurance or reinsurance group has its head office or is domiciled. Host Party refers to the territory in which an insurance or reinsurance group has operations, but is not where the group's worldwide parent has its head office or is domiciled.

Reinsurance. The Covered Agreement eliminates both collateral and local presence requirements for reinsurers operating on a cross-border basis in the EU and the US. While the commitments regarding reinsurance are mutually applicable to both jurisdictions, the main goals of these provisions were to provide collateral relief to EU reinsurers and relief from local presence laws that began affecting US reinsurers operating in the EU.

The collateral relief is significant, but not absolute or complete, and has several critical conditions. Most importantly, the collateral relief provided in the Covered Agreement is only prospective, applying to reinsurance agreements entered into, amended or renewed after the Covered Agreement takes effect and only with respect to losses incurred and reserves reported from and after the effective date of the new, amended or renewed reinsurance agreement. The Covered Agreement also does not interfere with private agreements for reinsurance collateral – it explicitly does "limit or in any way alter the capacity of parties to a reinsurance agreement to agree on requirements for collateral."

In addition, reduced collateral is only applicable to assuming reinsurers that have capital and surplus or own funds of €226 million or US$250 million and a Solvency II ratio of 100% SCR or 300% of US Authorized Control Level risk based capital (RBC); if the assuming reinsurer "is presently participating" in a solvent scheme of arrangement, it must post 100% collateral to the ceding insurer consistent with the terms of the scheme; and fulfillment of various reporting requirements.

Group Supervision. The Covered Agreement sets forth rules regarding the exercise of group supervision by the EU and US over insurance holding companies from the other jurisdiction. The practical effect of the group supervision provision is that a Host supervisor cannot exert group supervisory authority over entities in a group's organizational chart above the undertaking based in its jurisdiction, but it has unlimited group supervisory authority over any direct and indirect subsidiaries of a holding company established in the Host supervisor's territory, regardless of where in the world any subsidiary is domiciled or transacts business.

There are several exceptions to this limit on extraterritorial group supervision. The Host supervisor is entitled to request and obtain information, including copies of an insurer's group Own Risk and Solvency Assessment (ORSA) and "equivalent" information. Additionally, "prudential insurance group supervision reporting requirements" of a Host supervisor can be applied at the global parent level of an insurer if such reporting requirements "directly relate to the risk of a serious impact on the ability of undertakings within the insurance or reinsurance group to pay claims in the territory of the Host Party." Further, a Host supervisor can request and obtain information from a local insurer or reinsurer about its worldwide parent undertaking, even if it is located in the other territory "for purposes of prudential insurance group supervision, where such information is deemed necessary by the Host supervisory authority to protect against serious harm to policyholders or serious threat to financial stability or a serious impact on the ability of an insurer or reinsurer to pay its claims in the territory of the Host supervisory authority."

If a Host supervisor receives information that "exposes any serious threat to policyholder protection or financial stability in the territory of the Host supervisory authority, that Host supervisory authority may impose preventive, corrective, or otherwise responsive measures with respect to insurers or reinsurers in the Host Party". This could allow either the EU or US to impose additional capital requirements on the Host Party insurance subsidiaries of the other jurisdiction's holding company (and any subsidiaries of those subsidiaries) based on serious threats revealed to the Host Party's solvency or financial stability.

The provision in the Covered Agreement that has created the most controversy is the group capital assessment provision. An insurer or reinsurer is protected from worldwide group supervision of a Host supervisor if its Host supervisor imposes a global group capital assessment. The group capital assessment must: (i) provides "a worldwide group capital calculation capturing risk at the level of the entire group, including the worldwide parent undertaking of the insurance or reinsurance group, which may affect the insurance or reinsurance operations and activities occurring in the territory of the other Party" and (ii) provides such jurisdiction with the authority to "impose preventative, corrective, or otherwise responsive measures on the basis of the assessment, including requiring, where appropriate, capital measures." (Emphasis added).

"Worldwide parent undertaking" is defined as "the ultimate parent undertaking of a group" and does not appear limited to the entity that controls all of the insurance companies in a group. This group capital assessment requirement means that a US holding company would still be subject to EU global group capital requirements unless the holding company's home state has established a global group calculation requirement for that holding company and has authority to take action based on the results.

The Solvency II group capital standards meet these requirements, so this provision obviously is aimed at the US where no such group capital standards currently exist. The Federal Reserve Board (Fed) and the NAIC are currently developing capital standards, which may qualify under the provision. The Covered Agreement group capital assessment provision could be a strong impetus for the Fed and states to implement group capital assessments with enforceable consequences for US insurance holding companies doing business in the EU.

Exchange of Information. Finally, the Covered Agreement encourages US and EU insurance regulators to share information on a confidential basis. An annex to the Covered Agreement sets forth a model for a memorandum of understanding on information exchange which jurisdictions may adopt.

Additional Considerations

- The Covered Agreement is not yet signed by either party. In the US, it must be signed by the new Secretary of the Treasury and USTR Representative. With a new US Presidential Administration, it is unknown what actions will be taken and when.
- The Covered Agreement's provisions can preempt inconsistent state insurance measures, which include more than laws and regulations, but also administrative rulings, bulletins, guidelines or practices (including so-called "desk drawer rules" that have never been formally adopted into law or regulation). Under the Covered Agreement, a preemption determination is to be completed within 60 months of after execution of the Covered Agreement, prioritizing evaluation of those states with the highest volume of gross ceded reinsurance.
- The Covered Agreement may be terminated at any time (with or without cause) upon prior written notification (90 or 180 days) or amended upon mutual consent. Mandatory consultation through the Joint Committee is required prior to the termination or amendment of the Covered Agreement. The Joint Committee is made up of representatives of the US and EU, but the Covered Agreement does not spell out the number and identity of these representatives and does not appear to include state insurance regulators. This means that the Covered Agreement could be terminated relatively easily by either party.

Congressional Response

The new Chairman of Housing and Insurance Subcommittee of the Financial Services Committee, Sean Duffy (R-WI), held a hearing on the Covered Agreement on February 16, 2017. We expect the Chairman and other House Republicans to be hostile to the Covered Agreement for two main reasons including :1) the precedent it sets for federal preemption of state insurance laws; and 2) concerns related to the Covered Agreement's potential for retroactive application and the resulting impact on domestic insurers. Because there is no precedent for these types of agreements, it is unclear what, if anything, the Trump Administration can do to derail the Covered Agreement (assuming President Trump wants to). Accordingly, while the Covered Agreement may come under heavy criticism, it is unlikely to change the parameters and timeline of the existing agreement.

Ultimate implementation of the Covered Agreement will depend on the political will of the two main US political parties – and the prevailing industry reaction to it. The conclusion of the negotiations is significant as it demonstrates that the EU and the US can reach agreement on regulatory issues, despite the recent history of considerable disagreement between these two jurisdictions. However, numerous related issues and dynamics must be addressed, including the fact that post Brexit the UK will not be a party to the Covered Agreement. It also remains to be seen what changes will be made to Solvency II in the coming years and how they could impact the Covered Agreement. It will, therefore, be important to monitor developments regarding the Covered Agreement over the coming months.

US FEDERAL ELECTIONS AND LEGISLATIVE AND REGULATORY DEVELOPMENTS

Post-Election Update and the Trump Effect

President Donald Trump entered office on January 20, 2017, with an aggressive agenda for his first 100 days, pledging action on his campaign promises from repealing the Patient Protection and Affordable Care Act (ACA) to renegotiating trade deals. While many of his promises will ultimately require congressional action, the President has signed a number of executive orders to move forward with his proposals. Executive orders are legally binding directives issued by the president to federal administrative agencies.

In his very first order, President Trump gave relevant agencies authority to grant waivers, exemptions and delays of actions under the provisions in the ACA. His reasoning is that it would minimize the economic burden of the ACA pending congressional repeal. Other executive orders may indirectly impact the insurance industry, such as:

- The Executive Order Expediting Environmental Reviews and Approvals For High Priority Infrastructure Projects. This executive order could impact the insurance industry's interest in investment in infrastructure project, as discussed below.
- The Executive Order Reducing Regulation and Controlling Regulatory Costs. This executive order would require the executive branch to eliminate two regulations for every new one that is put into effect, arguing that it will reduce a major burden on small businesses in the US. This could impact the insurance industry because in the past few years multiple federal agencies directly or indirectly issued regulations that impact the insurance industry. With the new President's agenda to repeal or reduce the burden of Dodd-Frank and the ACA, some insurance regulations may be rescinded.
- The Executive Order on Core Principles for Regulating the United States Financial System sets core principles of financial regulation of the Administration, including preventing taxpayer bailouts, rigorously analyzing regulatory impact to address systemic risk and market failures, empowering Americans to make independent financial decisions. Although, the executive order was widely characterized as commencing a roll-back of financial regulations, including Dodd-Frank and the Fiduciary Rule, it did not have immediate impact on financial regulation and the President drafted a Presidential Memorandum addressed to the Department of Labor regarding the Fiduciary Rule (discussed below). The executive order also directs the Secretary of Treasury to consult with the heads of the member agencies of the FSOC and report to the President within 120 days (from February 3, 2017 and periodically thereafter) on the extent to which existing laws, treaties, regulations, guidance, reporting and recordkeeping requirements and other government policies and actions that have been taken promote or inhibit the Core Principles.

The Core Principles set forth are:

- **Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth**
- **Prevent taxpayer-funded bailouts**
- **Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry**
- **Enable American companies to be competitive with foreign firms in domestic and foreign markets**
- **Advance American interest in international regulatory negotiations and meetings**
- **Make regulation efficient, effective, and appropriately tailored and restore public accountability within federal regulatory agencies and rationalize the federal regulatory framework.**

What the 2016 Federal Elections Mean for Insurance

The Republican Party swept the 2016 elections at multiple levels of government. Republicans won the White House and maintained control of the US Senate and the US House of Representatives. Republicans also won at the state level, increasing the number of Republican governors to 33 and the control of both chambers of state legislatures to 32 states, while Democrats only have total control of six states. Republicans have a "political trifecta" in 24 of the 32 states (meaning Republican governor with Republican-controlled legislatures). In contrast, Democrats have a "political trifecta" in just six states.

With the balance of power at the federal level squarely in the hands of the Republican Party, it remains to be seen whether promises that the Republicans have made that will impact the insurance industry will be carried out. Adding to the mix, President Trump has demonstrated his propensity to take executive action where he deems necessary. Therefore, every avenue of policymaking at the federal level must be monitored. Particularly, insurance policy will be set by the House Financial Services Committees and the Senate Banking Committee of the 115th Congress and the Department of Treasury of the Trump Administration (not to mention President Trump, directly).

Overview of the Outcome of the Federal Elections

- There are 52 Republicans in the Senate and 48 in the Democratic caucus (including two Independents). Democrats

gained 6 seats in the House; however, the Republicans still control a comfortably large GOP majority.

- Senator Mitch McConnell was re-elected Senate majority leader and Representative Paul Ryan was re-elected as Speaker of the House.
- Despite Republicans controlling both the House and Senate, they lack a filibuster or veto-proof majority, which will affect what legislation can both pass Congress and be signed into law. President Trump has been up front about his intent to use his position of influence in the legislative process and his ability to take executive action.

US Senate

- The 115th Congress has two new Senators: Tammy Duckworth(D-IL); Maggie Hassan (D-NH),

US Senate		
	Democratic Caucus	Republican Caucus
Pre-Election	44 Democrats +2 Independents	54 Republicans
Post-Election	46 Democrats +2 Independents	52 Republicans

US House of Representatives

- Republicans maintained their majority in the house by 47 seats, despite losing six seat in house races across the country

US House of Representatives		
	Democratic Caucus	Republican Caucus
Pre-Election	188 Democrats	247 Republicans
Post-Election	194 Democrats	241 Republicans

Key Congressional Committees

There was only one change to the leadership of the Congressional committees that cover insurance matters. We do not anticipate the change in leadership to impact the focus of the committees:

- **Senate Banking Committee.** With Republicans maintaining control, Senate leadership and committee chairmen will remain largely intact; however, the Senate Banking Committee faced a change in leadership in 2017 as a result of term-limits affecting the Republican chairman. Senate Banking Committee Chairman and Senator Sherrod Brown (D-OH) will continue as the ranking member of the committee.
- **House Financial Services Committee.** The current chairman of the House Committee on Financial Services is Representative Jeb Hensarling (R-TX). Representative Maxine Waters (D-CA) returns as the ranking Democrat on the committee. Representative Sean Duffy (R-WI) chairs the Housing and Insurance Subcommittee. Representative Emanuel Cleaver (D-MO) is the subcommittee ranking member.

Federal Agencies and Outlook

President Trump enters into office at an interesting time for the insurance industry. The Federal Insurance Office, which was established after passage of Dodd-Frank, has significantly increased the role of the federal government in insurance regulatory matters. Other federal agencies, including the Department of Housing and Urban Development (HUD) through its "disparate impact" rule, have quietly crept into the regulation of insurance as well. In addition, efforts by international supervisory bodies, such as the IAIS and the FSB, with alleged complicity from FIO and the previous Administration, have challenged the efficacy of the US system of state-based insurance regulation.

Broadly speaking, we believe that the Trump Administration – with the help of a Republican-controlled Congress – will look to systematically decrease the influence of the federal government in insurance regulatory matters. We also expect US representatives at the IAIS and FSB to more aggressively promote and defend the US system of state-based insurance regulation in various international fora.

Below are some of the insurance policy matters we expect to be addressed in the 115th Congress:

Financial Regulatory Reform

Early on in the 115th Congress, we expect the chairman of the House Committee on Financial Services, Jeb Hensarling (R-TX), to move his version of financial regulatory reform, The Financial CHOICE Act, through the Committee and on to the floor of the US House of Representatives for a vote. The CHOICE Act would repeal large swaths of Dodd-Frank, including retroactively repealing the authority of the FSOC to designate firms as systemically important (*i.e.*, SIFI) and restructuring the Consumer Financial Protection Bureau (CFPB) by replacing the current single director with a bipartisan five-member commission that would be subject to Congressional oversight and appropriations.

More specific to insurance, the CHOICE Act would merge and reform the FIO and the Independent Member Having Insurance Expertise on the FSOC (i.e., Roy Woodall) into one unified Independent Insurance Advocate (IIA). The IIA would be appointed by the President, subject to advice and consent by the US Senate, for a six-year term and would be housed as an independent office within the US Department of the

Treasury. The IIA would replace the Independent Member Having Insurance Expertise as the voting FSOC Member and would coordinate federal efforts on prudential aspects of insurance, including representing the US at the IAIS and negotiating covered agreements. The IIA would also assist Treasury in administering the Terrorism Risk Insurance Program. The IIA would be mandated to testify before Congress twice per year to discuss the activities and objective of the office.

If the Financial CHOICE Act remains similar to the legislative text released in the last Congress, we expect the bill to narrowly pass out of the House Committee on Financial Services and have a similar result on the House Floor.

We expect the US Senate to explore its version of regulatory reform – likely more bipartisan – closer to Spring of 2017. Mike Crapo (R-ID), the chairman of the Senate Committee on Banking, Housing and Urban Affairs, and ranking member Sherrod Brown (D-OH) have signaled a willingness to work together on comprehensive regulatory reform; however, Senator Brown has stated publicly that those efforts should be solely focused on community banks. We expect Chairman Crapo to attempt to find common ground with ranking member Brown and moderate Banking Committee Democrats early on in the 115th Congress. However, if those efforts appear to be slow-going or the Democrats do not open up negotiations beyond regulatory reform for community banks, we expect the Republicans to go it alone.

In the last Congress, under the chairmanship of Richard Shelby (R-AL), the Banking Committee passed the Financial Regulatory Improvement Act along party lines. That bill had eight titles and included a broad range of regulatory relief and other provisions that would have amended Dodd-Frank. Title IV of the bill included three sections directly related to insurance. Section 401 included a "Sense of the Congress" provision that reaffirms McCarran-Ferguson and the system of state-based insurance regulation. Section 402 ensured that insurance policyholders would be protected from having their policies put at risk by their insurance company to shore up a distressed affiliated depository institution (this provision was subsequently included in the Consolidated Appropriations Act of 2016 and signed into law). Section 403 would have required additional reporting requirements and consultative measures surrounding ongoing international negotiations to create insurance regulatory standards. The bill also included provisions that would reform the process for designating non-bank SIFIs by requiring FSOC to provide more information to companies related to designation criteria and to give them more opportunities to take actions to avoid or reverse SIFI designations.

While we don't expect the Financial Regulatory Improvement Act to be the vehicle for financial regulatory reform in the Senate during the 115th Congress, we do expect a lot of the insurance-specific reforms mentioned above to be included in whatever bill is considered.

If each chamber passes a financial regulatory reform bill, a Congressional Conference Committee will be formed (with designated representatives from the House and Senate) to hash out the differences between their respective bills so they can send one final bill to the President for his signature.

The Financial Stability Oversight Council and Federal Insurance Office Activities

Congress may make changes to Dodd-Frank that trim the powers of the FSOC. In recent years, FSOC has been heavily scrutinized by lawmakers, particularly for its authority to designate non-bank entities as SIFIs, whose collapse could pose a threat to the overall financial stability of the US. Companies labeled SIFIs are subject to enhanced regulatory oversight.

The survival of FSOC under Dodd-Frank may be in jeopardy in the Trump Administration or during the tenure of the new Congress. The FSOC's authority to designate SIFIs was already challenged in March 2016 when a federal judge overturned FSOC's decision to name MetLife as a SIFI. Although FSOC appealed the judge's ruling to the D.C. Circuit (oral arguments were heard in October 2016, as discussed above), the Trump Administration may take swift action by withdrawing FSOC's appeal of the decision in the MetLife case. Maintaining the lower district court's ruling would sustain the procedural limitations on FSOC's ability to designate nonbank SIFIs. The new Congress may also amend Dodd-Frank (or repeal Dodd-Frank in whole or in part) to eliminate FSOC's ability to designate SIFIs.

Additionally, the US has been represented in the international discussions by a coalition known as Team USA, consisting of officials from the Federal Reserve Bank (Fed), the FIO and the NAIC. The US team's approach to the discussions and negotiations could be altered if the Trump Administration or Congress changes.

Dodd-Frank to limit or eliminate the FIO's authority. At this point in time, it is still difficult to predict what will happen. President Trump's new Secretary of the Treasury, Steven Mnuchin, has not taken a definitive position on insurance matters. Indeed, the dynamics of Team USA could change depending on who is tapped to lead the FIO (as discussed above). Further the NAIC has called for its termination, which would occur if Dodd-Frank is repealed in full.

International Insurance Matters

In the previous Congress, Senator Dean Heller (R-NV) and Senator Jon Tester (D-MT) introduced S. 1086, the International Insurance Capital Standards Accountability Act. The bill would create an " Insurance Policy Advisory Committee on International Capital Standards and Other Insurance Issues" – comprised of

insurance experts to advise federal insurance supervisors and regulators throughout the global capital standard development phase. The bill would also require periodic reports, testimony, updates and studies from the Fed and the Treasury on any regulatory developments at the IAIS as well as the impact of international capital standards on US policyholders and companies.

On the House side, Representative Blaine Luetkemeyer (R-MO) introduced H.R. 5143, the Transparent Insurance Standards Act. The bill, which passed the House of Representatives on December 7, 2016, would establish guardrails around what US federal officials could agree to in overseas negotiations. In addition to requiring that any international insurance agreement ensure policyholder protection, increase transparency and recognize the United States' state-based model of insurance regulation, the legislation would require the Federal Reserve and the Department of the Treasury to publish any proposed international standard in the Federal Register and allow for public comment. The bill would also provide the US Congress the opportunity to reject any agreement made overseas.

We expect both of these bills to be re-introduced in the 115th Congress. We also expect each of these bills to be included in the legislative text of the broader regulatory reform bills being considered in both the House and Senate, respectively. Therefore, we think there is a decent possibility that some version of international insurance reform will be signed into law in this Congress.

Insurance Capital Standards

The passage of The Insurance Capital Standards Act in 2014 gave the Fed the flexibility to develop insurance-specific standards for those insurers subject to Fed supervision, including insurers that own banks, thrifts or are designated as SIFIs by FSOC.

In June 2016, the Fed approved an advance notice of proposed rulemaking (ANPR) inviting comment on a conceptual framework for capital standards that could apply to those insurers. The Fed is currently considering a variety of options for the domestic capital standard that reflects the unique risks of certain insurance lines, mix of business and other factors. On multiple occasions the Fed has stated its commitment to tailoring its supervisory approach to the business of insurance, reflecting insurers' different business models and degree of systemic importance.

More specifically, the Fed is considering two options: the "Building Block Approach" and the "Consolidated Approach." The Building Block Approach would aggregate capital resources and capital requirements across different legal entities in an insurance group to calculate combined qualifying and required capital, subject to various adjustments concerning factors such as differences in accounting practices and cross jurisdictional differences. It would draw upon capital requirements set by local regulators of each legal entity, and in so doing has received largely favorable reaction from US regulators and insurers. The Consolidated Approach would take a fully consolidated approach to qualifying capital and required capital, using risk weights and risk factors that are appropriate for the longer term nature of most insurance liabilities. In deciding to expose these two approaches for comment in the ANPR the Fed expressly rejected an approach based on the Solvency II framework.

We expect stakeholder engagement to continue through the next Administration and the rulemaking process to continue with little disruption in 2017.

ACA Repeal and Replace

President Trump and members of the Republican party have vowed that their top priority is to repeal and replace the ACA. On President Trump's first day in office, he signed an executive order instructing federal agencies to roll back ACA implementation. Upon returning to Capitol Hill, the Senate began work on a budget bill that asked committees and lawmakers for ways to remove key funding components from the law, fulfilling Senate Majority Leader Mitch McConnell's (R-KY) promise to start repealing the ACA immediately. Some Republicans have suggested taking as long as three years to craft the ACA replacement, but Senator McConnell has not committed to such a strategy. In the meantime, House Speaker Paul Ryan (R-WI) pledged that Republicans will complete legislation to repeal and

replace the ACA in 2017. The first step towards fulfilling that pledge was made on March 6, 2017, when the House Republicans officially introduced the American Health Care Act (AHCA) and immediately starting committee consideration of the bill.

US Department of Labor Proposed Rule Impacting Life Insurance Industry

In the second week of the Trump Administration, President Trump signed a memorandum to roll back the Department of Labor's (DOL) fiduciary rule by asking the DOL to review the rule again and likely to delay its April 10th implementation. On April 20, 2015, the DOL released the proposed rule to change the definition of fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA). The impact to the insurance industry would have been on certain annuity products (specifically, guaranteed lifetime income annuities). Critics contend that the DOL proposed rule would restrict access to information and education about annuities. The life insurance industry has reacted strongly against the rule and filed voluminous comments in response to the DOL rule making procedures. Their concern is that disclosure requirements and the heightened prospect of private litigation against advisors could force advisors away from marketing annuities altogether.

Cybersecurity

The Cybersecurity Act of 2015 established legal protections for private and public sector sharing of cybersecurity threat information. Following its passage, Congress has focused on conducting oversight of the law's implementation by the Department of Homeland Security (DHS). This year Congress will continue an active oversight role in the area of cybersecurity, including on private sector information sharing through the DHS portal and the Russian hacking allegations. The House Homeland Security Committee has identified legislation to reorganize DHS's cyber operations as a top priority. Key cybersecurity lawmakers are working with the Trump Administration on the cybersecurity Executive Order.

During 2016, Congress continued deliberating over a federal data security and breach notification law. Although there were a handful of bills under consideration in both the House and Senate, inter-industry disagreements over what parties are responsible for data breach notification and whether states should be fully preempted by federal law derailed the opportunity for consensus.

This year, data security and breach notification legislation is farther down the list of legislative priorities after repeal of the ACA, tax reform and blocking implementation of various Obama Administration regulations.

Agent and Broker Licensing

The National Association of Registered Agents and Brokers Reform Act was signed into law on January 12, 2015 (passed as Title II of H.R. 26). The bill allows insurance agents and brokers who are licensed in good standing in their home states to apply for membership to the National Association of Registered Agents and Brokers (NARAB), which will allow them to operate in multiple states. NARAB will be a private, non-profit entity that will be overseen by a board made up of five appointees from the insurance industry and eight state insurance commissioners. The Board was mandated to be up and running by January of 2017; however, none of the ten members nominated by the Obama Administration were confirmed by the Senate (unrelated to their qualifications). Given that the nominations all expired at the conclusion of the 114th Congress, the Trump Administration will be required to submit new nominees (or resubmit previous nominees). However, the general chaos of the new Administration's efforts to staff the federal agencies will likely further delay any progress on the NARAB board.

Terrorism Risk Insurance

We expect the House and Senate Committees to continue to oversee the implementation of reforms passed in the Terrorism Risk Insurance Program Reauthorization Act of 2015 (H.R. 26 in the 114th Congress). One reform included in the Act directed the Treasury Secretary to establish and appoint an Advisory Committee on Risk-Sharing Mechanisms (ACRSM) to give advice, make recommendations and encourage the creation of non-governmental risk sharing mechanisms to support private market reinsurance capacity for protection against losses arising from acts of terrorism. The ACRSM held three meetings in 2016 and the Committee is currently devising suggested reforms to the Terrorism Risk Insurance Program that would increase private-market participation in the terrorism risk insurance marketplace. We expect the ACRSM report and recommendation to be released sometime in late 2017.

National Flood Insurance Program

In 2012, Congress passed the Biggert-Waters Flood Insurance Reform Act which reauthorized the National Flood Insurance Program (NFIP) through Sept. 30, 2017. With the expiration of the NFIP quickly approaching, we expect flood insurance reform to take center stage early on in the 115th Congress.

Despite expectations that the passage of Biggert-Waters would help shore up the fiscal condition of the NFIP and improve its administration, the Program remains US$24 billion in debt.

There are many reasons the fiscal condition of the Program has remained bleak, including the impact of Superstorm Sandy and the

passage of the Homeowner Flood Insurance Affordability Act of 2014, which repealed many of the rate and underwriting reforms mandated by Biggert-Waters.

Given the fiscal condition and perceived mismanagement of the NFIP, we expect Republican reform efforts, particularly in the House, to be far-reaching. In a recent speech, Financial Services Committee Chairman Hensarling stated his intention to pass a reauthorization bill that will "begin the transition to a more competitive, innovative and sustainable flood insurance market where consumers have real choices, and where private capital has a significant role." Those efforts were jumpstarted in the recent lame duck session of Congress with the release of a draft of principles by previous Housing and Insurance Subcommittee Chairman Blaine Luetkemeyer (R-MO). Those draft principles include the following reforms:

- Remove impediments to private capital, including the removal of the NFIP's non-compete clause for write-your-own companies, and inclusion of the Ross-Murphy (H.R. 2901 in the 114th Congress)/Heller-Tester (S. 1679) legislation, which would make it easier for financial institutions to accept private flood policies to satisfy mandated coverage requirements.
- Put in place a requirement to cede a portion of the NFIP's risk annually to the reinsurance and/or capital markets.
- Put in place a requirement that the NFIP base customer premiums on actual replacement cost of homes rather than using a fixed national average (current practice).
- Provide a greater role for recent technological innovations in the mapping process.

Despite the fact that Chairman Luetkemeyer will be moving on from chairman of Housing and Insurance, we expect incoming Chairman Sean Duffy (R-WI), to maintain a good amount of these reforms. We also expect House Democrats, including Financial Services Committee ranking member Maxine Waters (D-CA), to push back against Republican efforts to transition to a private market for flood insurance.

The Senate has been a lot less active on flood issues in the 114th Congress; however, Banking Committee Chairman Mike Crapo (R-ID) has stated his intention to ramp up the Committee's efforts early on in 2017. We expect many of the flood reforms in the Senate to be more bipartisan and a bit less ambitious than what will come out of the House. Unlike the House side, the legislative process in the Senate will likely be more welcoming of reforms that would improve the existing program, including streamlining the claims process and offering policyholders optional enhancements to existing coverage or additional coverage for current exclusions.

HUD Disparate Impact Theory

In 2013, the HUD issued a final rule to formalize the national standard for determining whether a housing practice violates the Fair Housing Act as the result of unlawful discrimination. The rule codifies the use of "disparate impact" analysis to prove allegations of unlawful discrimination with regards to homeowners' insurance. This means that any factor used by insurers to assess risk could be challenged if it produces statistically disproportionate outcomes among demographic groups. The rule will apply in situations where there was no intent to illegally discriminate, and where all policyholders and applicants for insurance were subjected to the same underwriting and pricing criteria without regard to race, ethnicity or any other prohibited characteristic. In August 2014, the Texas Department of Housing and Community Affairs requested that the US Supreme Court consider the question of whether disparate impact claims cognizable under the Fair Housing Act; and the court granted certiorari on that question. On June 25, 2015, the Supreme Court upheld the application of disparate impact under the FHA in a surprise five-to-four decision. The recently confirmed Secretary of HUD, Dr. Ben Carson, has made statements that lead us to believe he is opposed to the use of the disparate impact theory to bridge the gaps in income and racial disparity. Therefore, we expect HUD to consider removing or amending HUD's disparate impact rule.

US Sanctions

Economic and trade sanctions continue to be a major tool in the US foreign policy toolbox, often the first and most popular option for policymakers, in shaping the US response to world events. The year 2016 will primarily be known for the relaxation or removal of sanctions as a tool for rewarding or encouraging desired behavior of foreign regimes in Burma, Cuba, Iran and Sudan.

Burma

On October 7, 2016, President Barack Obama signed Executive Order 13742, terminating Burma sanctions by revoking all prior Executive Orders dealing with Burma and waiving financial and blocking sanctions in the Tom Lantos Block Burmese Jade Act of 2008. The Order revokes restrictions on more than 200 Burmese businesses, banks and individuals designated as Specially Designated Nationals (SDNs); permits the import of Burmese jadeite and rubies; and allows investment reporting through the State Department's Responsible Investment Reporting Requirements to be made on a voluntary basis. This major policy shift followed a Presidential Proclamation on September 14, 2016, which restored preferential treatment for Burma as a beneficiary developing country, essentially allowing Burma to receive duty-free treatment on more than 5,000 products exported to the United States. EO 13742 was a response to Burma's recent pro-democracy advances,

including the release of political prisoners and an overall increase in fundamental freedoms following the Burmese November 2015 elections.

Cuba

The year 2016 saw the ongoing relaxation of US sanctions toward Cuba, begun a year earlier on January 16, 2015. Significant steps to relax US Cuba sanctions in 2016 included:

- Promulgation of revisions to the Cuban Assets Control Regulations (CACR) by the Office of Foreign Assets Control (OFAC) on January 27 that removed restrictions on payment and financing terms for the export of licensed, non-agricultural goods to Cuba; authorized expanded air carrier services; and expanded permissible travel to Cuba to include trips by US persons to organize such events as professional conferences, public performances and athletic competitions
- The signing of an agreement on February 16 between the US Departments of Transportation and State and Cuban aviation officials to reestablish regularly scheduled commercial air services between the two countries
- The first visit by a current US President to Cuba in decades, on March 21, when President Obama met with Cuban President Raul Castro to discuss diplomatic relations as well as ways to promote US- Cuban business on the island
- The publication of updated Frequently Asked Questions (FAQ) regarding Cuba by OFAC on April 21 that added new FAQs 80 and 81 clarifying the permissibility of insurance coverage and claim processing " directly incident to activity authorized by general or specific license"
- The issuance of an Order by the US Department of Transportation on June 10 authorizing six US airlines to provide scheduled passenger flights between the US and Cuba
- The publication of new FAQs regarding Cuba by OFAC on October 14 that clarified financial institutions, including insurers, are not required to independently verify that an individual's travel to Cuba is authorized when processing travel-related transactions.

The death of Fidel Castro on November 25, 2016, contributed momentum toward normalization of the relationship between Cuba and the United States, although the policies of the new Trump Administration pose uncertainties for the direction of Cuba sanctions in 2017. Moreover, much of the US banking industry remains reluctant to fully utilize the available general licenses for transactions with Cuba (e.g., allowing establishment of correspondent accounts at Cuban financial institutions). While opportunities for Cuba-related insurance business will continue in 2017, insurer expectations should be tempered.

Iran

On January 16, 2016, known as Implement Day, the United States and European Union suspended or relaxed all nuclear-related sanctions on Iran. The action came after the International Atomic Energy Agency (IAEA) had verified that Iran had undertaken the nuclear suspensions to which it agreed in the Joint Comprehensive Plan of Action (JCPOA) on July 14, 2015. Sanctions relief is limited, however, to removing EU sanctions and only those US "secondary" sanctions applicable to non-US persons. "Primary" US sanctions, applicable to US persons and corporations, remain in place following Implementation Day. And even though EU and US secondary sanctions are repealed, there is a possibility of a snapback of those sanctions if Iran violates its nuclear commitments under the JCPOA.

One of the more significant developments for US corporations, including insurers with Iranian exposures in global insurance coverages, was the promulgation of General License H by OFAC providing limited sanctions relief to US parent companies. Since January 2013 entities that were "owned or controlled" by US persons had been subject to the same restrictions as their US parent companies. General License H authorized such foreign-based entities to engage in all activities that would be otherwise

prohibited for US persons, subject to a list of conditions and a narrowly defined role for the US parent vis-à-vis the Iranian business of its foreign-based subsidiary. A number of insurers found the provisions of General License H to be helpful, particularly for writing global reinsurance policies with a small exposure to Iranian risks. Other insurers found the provisions too limiting and applied to OFAC for a specific license for an expanded role as a US parent. To date OFAC has not responded to any of the insurers' specific license requests.

The status of Iran sanctions, and particularly the JCPOA, remain one of the many unknowns as the Trump Administration gets underway. Although promising to terminate or renegotiate the Iran nuclear agreement throughout his campaign, diplomatic and economic counter pressures may impact this promise. EU Council conclusions following the US elections expressing a "resolute commitment" to the full and effective implementation of the JCPA may pose diplomatic complications for repeal of the JCPOA. Also, OFAC licenses for sales of Boeing and Airbus aircraft to Iran issued in late 2016 may generate political and economic pressure to maintain the status quo of the JCPOA. Iran sanctions are thus a huge unknown as we enter 2017 with a new Administration and a Congress controlled by the same political party.

Russia

On December 29, 2016, President Obama issued Executive Order 13757 that amended Executive Order 13694, "Blocking the Property of Certain Persons Engaging in Significant Malicious Cyber-Enabled Activities." The amendment expanded the scope of EO-13694 to allow for the "imposition of sanctions on individuals and entities determined to be responsible for tampering, altering or causing the misappropriation of information with the purpose or effect of interfering with or undermining election processes or institutions." Sanctioned under the amended EO were six Russian individuals and five entities, including Russia's Federal Security Service (a.k.a. the FSB), the Russian Main Intelligence Directorate (AKA the GRU) and individuals linked to the GRU. Additionally, the President expelled 35 suspected Russian spies from the US. With the release on January 6, 2017, of intelligence officials' declassified version of the report, "Assessing Russian Intentions and Activities in Recent US Elections: The Analytic Process and Cyber Incident Attribution," additional Russian sanctions are a strong possibility in 2017, particularly from the US Congress. Thus, all transactions with persons in Sudan, all import and export transactions with Sudan and all transactions involving property in which the Government of Sudan has an interest are now authorized by general license.

Sudan

Effective January 18, 2017, OFAC suspended comprehensive US sanctions against Sudan. With the promulgation of new section 538.540 of the Sudanese Sanctions Regulations (SSR) on that date, OFAC authorized all transactions involving Sudan that had been previously prohibited under the SSR, Executive Order (EO) 13067 (Nov. 3, 1997) and EO-13412 (Oct. 13, 2006).

The new US policy towards Sudan was established on January 13, 2017, by President Obama in EO-13761, which conditionally revokes most provisions of EO 13067 and EO 13412 effective July 12, 2017, provided the Secretary of State, in consultation with Secretary of the Treasury, the Director of National Intelligence and the Administrator of the USAID, publishes a notice that "the Government of Sudan has sustained the positive actions that gave rise to this order...." It should be noted, however, that OFAC's general license and EO-13761 do not impact Sudanese individuals or entities blocked pursuant to EO-13400 of April 27, 2006, "Blocking Property of Persons in Connection With the Conflict in Sudan's Darfur Region." The property and interests in property of persons designated pursuant to E.O. 13400 remain blocked.

Kingpin Act

On May 5, 2016, OFAC designated the Waked Money Laundering Organization (Waked MLO) and its leaders as Specially Designated Narcotics Traffickers pursuant to the Foreign Narcotics Kingpin Designation Act (Kingpin Act). The OFAC designation extended to 68 companies tied to Waked MLO, including Grupo Wisa, S.A., a Panama holding company with extensive holdings in the real estate, construction, retail, hospitality and media sectors of the Panama economy. The designation of Grupo Wisa has had widespread impact on insurers and reinsurers who insure affiliates, business partners and clients of Grupo Wisa in Panama. Although OFAC has promulgated general licenses to allow limited recovery of amounts owed by Grupo Wisa or its affiliates to innocent third parties, the general licenses have had very limited impact on insurers' capacity to issue coverage or pay claims with connections to Grupo Wisa or one of its affiliates.

Insurance Enforcement Actions

OFAC continues to be active in scrutinizing sanctions for compliance of insurers. Two Finding of Violation (FOV) letters were issued to insurers in 2016 signaling apparent violations of the Foreign Narcotics Kingpin Sanctions Regulations. A FOV letter is a formal determination of a violation of sanctions but with no civil penalty consequence. On August 2, 2016, a life and health (L&H) insurance company was issued a FOV for failing to identify and block the health insurance policy and premium payments of a policy issued to an insured in 1992 who was subsequently designated as an SDNTK (narcotics kingpin) in 2009. Under the same set of facts, another L&H insurance company received a FOV letter for the failure of its wholly owned subsidiary, a third party administrator that administered the same health insurance policies of that L&H insurance company, to block the health insurance policy and premium payments of the L&H insurance company SDNTK policyholder.

NAIC AND STATE REGULATORY DEVELOPMENTS

2016 State Elections, Insurance Commissioners and the NAIC

The November elections yielded few new insurance commissioners and therefore did not significantly impact the ranks of the NAIC. The NAIC appeared to be in a defensive posture in 2016, state insurance commissioners were responding to a number of significant challenges, including changes in the Federal approach to insurance regulation, while facing a number of issues on the international front, including international capital standards and group supervision issues within the IAIS and the newly negotiated Covered Agreement with the EU.

Elections, Resignations and Appointments – Commissioners and the NAIC

Gubernatorial Races. As observers of US insurance regulation know, most commissioners are appointed by governors, so elections can change the make-up of US insurance policy-making bodies, including the NAIC. Regarding gubernatorial races involving governors who can appoint insurance commissioners:

- *Missouri:* Republican Eric Greitens defeated the Democratic candidate. As a result, the Republican candidate won the seat that was previously held by a Democrat. Therefore, the Democrat-appointed Director of Insurance, and former President of the NAIC, John Huff, resigned his position on February 6, 2017. The Acting Director is now John F. Rehagen, who has served as director of the Division of Insurance Company Regulation of the Department of Insurance, Financial Institutions and Professional Registration since January 2014.

- *New Hampshire:* Republican Chris Sununu defeated the Democratic candidate. As a result, the Republican candidate won the seat previously held by a Democrat. Nevertheless, there was no change to the Commissioner of Insurance as Commissioner Roger Sevigny was reappointed in June 2013 for a five-year term, which will end in 2018.

Insurance Commissioner Races and Resignations. In addition, influential commissioners did not succeed in being reelected or resigned for personal reasons unrelated to election results. Both scenarios resulted in new state insurance commissioners.

- *North Carolina:* Republican Mike Causey defeated the incumbent, Democrat Wayne Goodwin.

- *Delaware:* Democrat Trinidad Navarro defeated the Republican candidate. The seat was open as a result of Mr. Navarro defeating multiple-term Karen Weldin Stewart in the Democratic primary in September 2016.

- *Montana:* Republican Matt Rosendale defeated the Democratic candidate. The seat was open because Monica Lindeen, the sitting President of the NAIC, resigned her post due to term limits.

- *North Dakota:* Republican Jon Godfread defeated the Democratic candidate. The seat was open because Adam Hamm, the former President of the NAIC, decided not to seek another term.

NAIC Leadership

Although there was not a major turnover of insurance commissioners, the NAIC leadership will look different after the changes that took place in 2016. Former Pennsylvania Insurance Commissioner Michael Consedine was named CEO of the NAIC, effective February 1, 2017. Mr. Consedine succeeded former Senator Ben Nelson, whose term as CEO ended on January 31, 2016 (notably the NAIC took a full year to fill the position). Mr. Consedine is well known and respected in the industry, having served as an insurance commissioner and officer of the NAIC. When Mr. Consedine stepped down as Commissioner of Insurance, he was the Vice President of the NAIC (hence, he was in line to be NAIC president) and the chair of the NAIC International Insurance Relations (G) Committee. He also served on the Federal Advisory Committee on Insurance, which advises the FIO, and was extremely active on the international insurance regulatory stage. His presence at the NAIC will strengthen the US regulatory team dealing with international and federal issues affecting the US insurance industry.

NAIC 2016 OFFICERS	
President	Ted Nickel, Wisconsin Insurance Commissioner
President-Elect	Julie Mix McPeak, Tennessee Insurance Commissioner
Vice President	Eric A. Cioppa, Maine Superintendent of the Bureau of Insurance
Secretary – Treasurer	David Mattax, Texas Insurance Commissioner

NAIC Hearings on Solvency II Implementation

At its Summer 2016 National Meeting, the NAIC's International Insurance Relations (G) Committee heard from a panel of representatives from several US-based insurers who described their companies' adverse experiences with Solvency II implementation, including having to confront barriers to doing business in EU countries. Although the NAIC has not yet announced any formal plans to address these concerns, regulators clearly were sympathetic to the concerns of the panelists.

At the Fall 2016 National Meeting, however, the NAIC's possible reaction emerged during the meeting of the Reinsurance (E) Task Force, where regulators introduced the possibility that jurisdictions that impose barriers on US insurers related to Solvency II would be susceptible to a possible change in their

qualified jurisdiction status for purposes of credit for reinsurance.

The Qualified Jurisdiction (E) Working Group has been particularly interested in Germany, where it has determined that a physical presence requirement established by the BaFin could undermine the rules governing the determination of qualified jurisdictions result in a Qualified Jurisdiction's status being placed on probation, suspended or revoked.

The Reinsurance (E)Task Force requested its Qualified Jurisdiction (E) Working Group to continue to study EU member state implementation of Solvency II and to provide a written report with a recommendation regarding the qualified jurisdiction status of France, Germany, Ireland and the UK. If US-based companies continue to be adversely impacted by Solvency II implementation, the NAIC may be provoked to change the status of a Qualified Jurisdiction in retaliation.

Principles Based Reserving and the Clamp Down on Reserve Financing

Redundant Reserve Financing Transactions

Essentially finishing the NAIC's efforts to reform the use of life insurance reserve financing methods that many regulators find troubling, the Reinsurance Task Force adopted the Term and Universal Life Insurance Reserve Financing Model Regulation, which, in effect, codifies existing standards governing Triple X and A Triple X captives currently contained in AG 48. Regulators and interested parties (on both sides of the issue) pronounced the Model Regulation to be an acceptable and workable compromise. NAIC staff will prepare a project history memorandum to be submitted along with the Model Regulation for consideration by NAIC members as the new model works its way to formal adoption by the full NAIC. As is the case in all NAIC models, the focus now turns to what the handful of states in which these reserving transactions occur (i.e., the states where insurers that cede the risks, and the captives that reinsure them, are located) will do to adopt and enforce this new regulation.

Principles Based Reserving (PBR)

At the Fall National Meeting, the PBR Review (EX) Working Group discussed the 2016 PBR Company Pilot Project in which 11 companies are participating. Regulators participating in the Pilot Project have reviewed all company responses and scheduled follow-up conference calls to discuss questions. Next, a survey will be sent to companies participating in the Pilot Project, and a final written report will be drafted for submission to the PBR Implementation (EX) Task Force by the end of January 2017.

PBR is ultimately expected to become a state accreditation standard in 2020, meaning that states will be required to enact "significant elements" of the amendments to the Standard Valuation Law to maintain accreditation by the NAIC. The Financial Regulation Standards and Accreditation (F) Committee has exposed the Life Actuarial (A) Task Force's proposed significant elements for a 60-day public comment period ending February 8, 2017.

Group Capital Standards

The NAIC's disagreement with actions by international regulators is also part of the motivation for the work being done by the Group Capital Calculation Working Group. Launched in late 2015, the Working Group is still in the process of constructing a US group capital calculation tool using an RBC aggregation methodology, which is referred to as the Inventory Method. In the beginning, some interested parties saw it as possibly being a valid alternative to the ICS. To the dismay of some interested parties, however, the Working Group is struggling to find the correct balance between simplicity and accuracy in executing its charge. Currently, that struggle is focused on three specific issues: the factor to be used for non-insurance entities that are not subject to other capital requirements, the treatment of

non- insurance entities that are subject to capital requirements and the use of scalars for non-US insurers. During the Summer Meeting, NAIC staff presented a list of eight questions for discussion on these issues (to which a ninth question was added during the meeting). Although some regulators pushed the industry to try to respond quickly to these questions, interested parties who prefer a slower, more deliberate approach were successful in obtaining a 60-day comment period. The NAIC has announced plans to complete a calculation tool in 2019; however, it remains to be seen whether the calculation tool will be ready by that time.

Reinsurance Developments

As discussed above, the Reinsurance (E) Task Force requested that the Qualified Jurisdiction (E) Working Group study and report on EU member state implementation of Solvency II and its potential impact on Qualified Jurisdiction status. In addition, the Reinsurance Task Force held its own panel discussion regarding the problems faced by US reinsurers operating in the EU. The discussion included highlighting the actions EU regulators have taken that have adversely affected US and other non-EU reinsurers.

The Reinsurance (E) Task Force also adopted revisions to the Uniform Application Checklist for Certified Reinsurers in 2016. The revisions included parameters regarding the inclusion of a reconciliation of International Financial Reporting Standards to generally accepted accounting principles for audited financial reports; clarification regarding the acceptable age of financial strength ratings (i.e., maximum 15 years); and clarification on the funding of multi-beneficiary trusts.

Finally, in 2016, the NAIC adopted the new collateral rules for certified reinsurers as an accreditation standard. The 2011 revisions to the Model Credit for Reinsurance Law and Regulations (Model #785 and #786) that related to the certified reinsurer provisions were previously included as an optional standard, but in 2016 was voted to be required as an accreditation standard. This action by the NAIC is notable because when the process started, it was very controversial. This is one area where the NAIC was able to move a controversial concept from development to a nationwide and uniform standard. Three additional elements were adopted: (i) concentration risk; (ii) catastrophe recoverables deferral; and (iii) passporting. As an accreditation standard, a state is required to adopt the NAIC model act or regulation or risk losing its accredited status at the NAIC. States must adopt Model #785 and #786 by January 1, 2019.

Infrastructure Investments

The Valuation of Securities Task Force held a special session to explore the topic of infrastructure investments. The Task Force Chairwoman, former Director Anne Melissa Dowling (Illinois), highlighted the growing need for investing in the nation's infrastructure and noted that various national and international organizations have identified this growing need as a natural fit for insurance companies (especially life insurers), given the long term nature of many infrastructure investments and the long duration of life insurer liabilities.

The purpose of the special meeting was to identify and evaluate any potential impediments to insurers participating in infrastructure projects, and then respond with responsible solutions that do not encourage or improperly incentivize insurers to do anything that does not make sense from an investment perspective or is not financially prudent.

The meeting was organized into four panels to discuss the issue from different perspectives: actuarial, insurance industry, rating agencies and consumer. Panelists expressed a consensus that: (i) infrastructure investments are needed; (ii) various forms of infrastructure projects exist which need private capital investment; (iii) infrastructure investments provide lower default risk than other types of investments; and (iv) insurance companies already find some of these investments attractive, but their ability to make such investments is hindered by having limited access to such investments or by encountering regulatory impediments. Some panelists suggested that the Task Force consider adjusting the RBC charge as a way to stimulate further activity by insurance companies in such infrastructure investments.

Although the agenda of the meeting included a discussion of next steps, the Task Force did not discuss future plans or take any official action, but nevertheless appeared interested in continuing the discussion. Additionally, now that Director Dowling will no longer serve as the Chairwoman, the direction of the Task Force remains to be seen.

INNOVATION AND TECHNOLOGY IN INSURANCE

InsurTech/FinTech

The insurance industry has been relatively late to catch (or get hit) by the technology and innovation wave. But that has changed dramatically over the past few years as insurers continued to embrace technology to enhance business operations and opportunities. InsurTech companies and other technology providers envision ways to bring innovation and disruption to the insurance industry. Within this space we have seen innovation and disruption through startups and emerging growth companies. In addition, insurers and other financial institutions have rapidly grown both corporate venture capital "funds" and investing platforms, as well as digital innovation centers focused on disruptive rather than incremental technological advances. In addition, many insurers partner with incubators, accelerators and other "matchmaker" organizations, or with major venture capital funds, either to invest, or to partner and seek new distribution through, or services from, startups.

As the adoption of InsurTech innovation has increased, the level of competition among traditional insurance players, established technology companies and startups have intensified. Traditional insurance players need to invest or impactfully innovate to not be left behind as the technology players continue to accelerate solutions applicable to the insurance sector.

Allianz, for example, has Allianz X, a division focused on developing new InsurTech concepts and companies. Hiscox is among participants who helped back Indio, a commercial insurance broker platform. Liberty Mutual and USAA are among the backers behind Snapsheet, a startup developing virtual auto claims technology and services that recently raised US$20 million in new financing. Aviva has also committed resources and capital to its corporate venturing arm to invest in digital insurance solutions. AIA in Hong Kong has sponsored an accelerator to identify promising FinTech innovations suitable for the Asia insurance market. Munich Re, through HSB Ventures, has a digital innovation center in Silicon Valley and has been one of the most active of corporate venture capital investors.

Lemonade launched as a peer-to-peer insurer focused on homeowners and renters insurance. In addition, Root recently debuted as an auto insurance startup that uses telematics and a customer's smartphone to develop the cheapest rates for customers based on current driving data; Munich Re, Odyssey Re and Maiden Re are its reinsurance backers.

New venture capital firms are starting to look into the InsurTech startup industry. For example, a Des Moines-based venture capital firm backed by a consortium of insurance companies from across the country is looking to make early to growth-stage investments in innovative insurance technologies. The firm is interested in customer engagement, core systems, home automation, telematics, "big data" customer analytics, cybersecurity, IoT, regulatory technology, digital distribution, underwriting and claims processing. The new firm joins another insurance focused venture capital firm in Des Moines that helps startups – the Global Insurance Accelerator. The Accelerator was launched in 2013 with backing from seven insurance companies as well as the support of the Iowa Department of Insurance.

Large technology companies are also focusing on providing solutions to the insurance sector. Familiar names such as Google and Alibaba are investing in the insurance sector. These technology firms may be best suited to apply big data solutions, analytics and underwriting and other broad-based or high infrastructure technical applications. In addition, they may be able to exploit their existing products as a distribution network.

Plug and Play is the world's biggest startup accelerator. They are a global innovation platform that connects startups to corporations, and they invest in over 100 companies each year. Some of their success stories include PayPal, Dropbox, SoundHound and Lending Club. Their corporate partners include the innovation teams at some of the world's leading insurance companies such as Munich Re, Aviva, Aflac, Nationwide, Allianz, Travelers, Aon, Swiss Re, AIG, Westfield Insurance and State Farm.

InsurTech has grown rapidly over the last couple of years as technology solutions have proved to create more efficiency in insurance marketing , underwriting and claims processing. This has spurred more competition among traditional insurance industry players and technology companies to be among the first to adopt the next great InsurTech innovation, which has in turn incentivized startups to develop more innovative solutions in the insurance space. Unlike other technological developments that have been concentrated in a few technology centers, InsurTech and FinTech have started out being global almost from the outset. InsurTech innovation has been developed across various financial and technology centers and then customized to a particular jurisdiction to meet specific regulatory requirements and business practices.

In Asia, for example, mobile and online technologies are advanced and consumers are relatively open to using digital channels to evaluate and buy financial and insurance products. This has led such companies as Aviva to enter earlier this year into alliances with Tencent, a technology company, and Hillhouse Capital, a private equity fund focusing on technology, to sell insurance products through online channels in Hong Kong. InsurTech investments are also flowing from Asia to the West. Fosun, an investor in the financial services sector, recently invested in The Floow, a UK InsurTech company. This company develops smartphone software that tracks driver behavior and is used by insurers to set premiums.

Wealth and asset management is another area where InsurTech and FinTech are changing the landscape. In no other area do we see the level of board and C-suite attention to a single new issue.

Boards and chief officers must contest with the possibility – but far from a certainty – of disruptive competitive new entrants and new technologies. While there are a variety of strategies, from watchful waiting, seeking affinity and distribution through, or joint ventures with, startups, corporate venture capital and digital innovation and intellectual property acquisition and protection.

According to the most recent KPMG Pulse of FinTech report on investment activity in FinTech in 2016, InsurTech investments peaked in the first quarter, then fell in the second and third quarters. But KPMG still sees a positive outlook for FinTech and the InsurTech subsector in 2017.

We expect 2017 to see a continued focus on investment in InsurTech, albeit consolidating and capitalizing on investments made in 2016 rather than a push for new business. As we have seen in the FinTech space, increased customer demand for (and expectations of) technology-driven insurance and risk solutions has caused insurers to regard the InsurTech market as a way of more quickly acquiring the technology, know-how and experience to enhance their products and their digital presence. As the insurance regulators catch up with the momentum of new tech insurance products, we may see a rush to regulate the tech industry in the same way as in China, as discussed below, although we have not seen any indication of this as yet and signs are that the market is set to grow further in 2017.

Cybersecurity Issues

Federal Regulatory Developments

NIST Cybersecurity Framework Update

The National Institute of Standards and Technology (NIST) released proposed revisions to its Framework for Improving Critical Infrastructure Cybersecurity (Cybersecurity Framework) on January 10, 2017. The Cybersecurity Framework is widely accepted as the authoritative guidance on private sector cybersecurity, particularly for critical infrastructure, as well as for federal government agencies.

The latest draft is intended to "refine, clarify, and enhance" Version 1.0, released in February 2014, as required by Executive Order 13636 – Improving Critical Infrastructure Cybersecurity. The changes proposed in the draft were responses to public comments received from the NIST December 2015 Request for Information. The proposed changes provided new details on managing supply chain risk, clarified key terms and provided metrics on risk management measurement.

The notable changes in draft Version 1.1 include:

- *Additional information on mitigating supply-chain risks*. NIST expanded Section 3.3 ("Communicating Cybersecurity Requirements with Stakeholders") to address the importance of communicating and verifying cybersecurity requirements among stakeholders as part of cyber supply chain risk management (SCRM). In addition, NIST added SCRM as a property of the Implementation Tiers (Section 2.2) and to the Framework Core under the Identify Function.
- *A new section (Section 4.0) on cybersecurity measures and metrics*. NIST notes that by using metrics and measurements the Cybersecurity Framework can be used as the basis for assessing an organization's cybersecurity posture. According to the draft, "metrics" help "facilitate decision making and improve performance and accountability" while "measurements" are "quantifiable, observable, objective data supporting metrics." For example, organizations can measure system uptime – and this measurement can be used as a metric against which an individual responsible for developing and implementing appropriate safeguards to ensure delivery under the framework's Protect Function can be held accountable.

Comments to the draft Version 1.1 are due by April 10, 2017. After reviewing these comments and convening a workshop, NIST intends to publish a final Framework Version 1.1 in Fall 2017.

NIST reiterates that "[a]s with Version 1.0, use of the Version 1.1 is voluntary," and says that users of Version 1.1 may "customize the Framework to maximize organizational value."

NIST's encouragement of cybersecurity measures and metrics for internal organizational accountability could lead to evolving metrics that can also be used by third parties (*e.g.*, regulators) to hold organizations accountable under the framework. While it remains to be seen what the Federal Trade Commission (FTC) will do under the incoming Trump Administration, the FTC (and other regulators) could use such metrics as the bases for enforcement actions. Indeed, there is significant overlap between what the FTC considers to be "reasonable" security and the Cybersecurity Framework. According to the FTC's blog post on The NIST Cybersecurity Framework and the FTC, "The types of things the Framework calls for organizations to evaluate are the types of things the FTC has been evaluating for years in its Section 5 enforcement to determine whether a company's data security and its processes are reasonable. By identifying different risk management practices and defining different levels of implementation, the NIST Framework takes a similar approach to the FTC's long-standing Section 5 enforcement."

We anticipate that the Framework will continue to be the primary guidance for organizations to use in order to manage cyber-risk and there will be increased federal agency and sector specific mapping developed based upon the Framework.

National Cybersecurity Incident Response Plan

President Obama issued Presidential Policy Directive #41 (US Cyber Incident Coordination) in July 2016, which assigned DHS and other civilian agencies lead roles and responsibilities with respect to coordinating and responding to cyber-incidents. It also required the Secretary of Homeland Security, in coordination with the Attorney General, the Secretary of Defense and sector specific agencies to produce a National Cyber Incident Response Plan (Response Plan) providing a strategic framework for planning for and responding to cyber-incidents, which they issued on January 18, 2017, two days before the swearing in of President Trump.

The Response Plan is intended to implement a public-private partnership approach to mitigating, responding to and recovering from a cyberincident. The Response Plan reads as a detailed articulation of the current operational coordination and responsibilities of the US government, the private sector and state and local governments.

The Response Plan identifies what types of cyber-incidents should be reported to the federal government and is not limited to attacks on critical infrastructure or impacting national or economic security or public safety. It also covers attacks that could be of marginal severity although on a wide scale including attacks: resulting in a significant loss of data, system availability or control; affecting a large number of victims; or indicating unauthorized access to, or malicious software on, critical information technology systems. The Response Plan creates new voluntary reporting guidelines, which represent an expansion beyond attacks on critical infrastructure to also cover non-critical infrastructure that are not tied to larger national or economic security impacts.

The Cyber Incident Response Plan has prompted some private sector concern that the Presidential Policy Directive #41 transferred too much of the responsibility for response from the private sector to the federal government, a concern that is likely to resonate with the Trump Administration as it develops its cybersecurity plans.

Cybersecurity Commission Report

In February 2016, President Obama issued an Executive Order establishing the Commission on Enhancing Cybersecurity and requiring the Commission to provide recommendations on cybersecurity by December 2016. The Commission, composed of both private sector and academic experts, issued a report that focuses on: continued government and private sector collaboration on developing cyber-risk management practices and greater use of the NIST Cybersecurity Framework; streamlined federal government roles and responsibilities over cybersecurity; a DHS cyber-incident reporting program; and NIST guidance on sharing of organization interdependency and supply chain risk.

Overall the report contains some helpful recommendations and is one of many resources the Trump Administration is turning to in formulating its cybersecurity strategy, including the cybersecurity Executive Order.

Trump Administration Cybersecurity Policy Direction

President Trump has identified cybersecurity as an "immediate and top priority" especially with respect to upgrading Federal network security and protecting critical infrastructure.

Insurance is a subsector of the Financial Services Critical Infrastructure Sector, one of the 16 Critical Infrastructure Sectors identified by Presidential Policy Directive 21, Critical Infrastructure Security and Resilience.

The Trump Administration plans to take a stronger stand on cyber-risk deterrence both by the US government and by the private sector. The President plans to issue a cybersecurity Executive Order on protecting and advancing the cybersecurity and risk management of critical infrastructure and Executive Branch departments and agencies, which will outline areas for federal government examination and reporting within specific timeframes. The Secretary of Defense, Secretary of Homeland Security, the Director of the FBI, the Director of National Intelligence are required to identify authorities and capabilities within agencies to support critical infrastructure cybersecurity. The Executive Order is expected to reflect the Trump Administration's prioritization of bolstering critical infrastructure cybersecurity and risk management including in areas where there are currently obstacles.

NAIC Developments

NAIC Insurance Data Security Model Law

The NAIC Cybersecurity (EX) Task Force (now the Cybersecurity (EX) Working Group) met regularly throughout 2016 to update regulators and interested parties on various cybersecurity topics.

The Task Force announced that the Commission on Enhancing National Cybersecurity issued a request for information to gather data from stakeholders on a variety of cybersecurity issues, including on the topic of cybersecurity insurance (which was due September 9). The highlight of the year was ongoing discussions about the revised draft of the Insurance Data Security Model Law (Cybersecurity Model Law), which was released for comment in August 2016. The purpose of the Cybersecurity Model Law is "establish the exclusive standards in [the] state for data security and investigation and notification of a data breach applicable to licensees." "Licensee" is defined under the Cybersecurity Model

Law as "any person or entity licensed, authorized to operate, or registered pursuant to insurance laws of [the] state."

A second version of the Cybersecurity Model Law, dated as of August 17, was distributed after the Task Force had received over 40 comment letters from industry, trade associations and consumer representatives to a version of the model law released last March. Nevertheless, the second version did not garner support from those who submitted comments. In fact, so many interested persons wanted to share their objections to the revised Model Law that Chairman Adam Hamm had to strictly limit each commenter's time to speak to two minutes. Representatives from the trade associations, such as ACLI, AIA, PCI, RAA, the IIABA and other agent/broker organizations objected to (among other things):

- The potential for lack of uniformity due to the broad grant of authority to insurance commissioners
- The lack of clarity regarding the timing and content of breach notification
- Unclear definitions of terms, such as the term "personal information," and the use of vague, undefined terms such as "state of the art techniques"

These commenters implored the Task Force to spend more time reworking the draft. The common message was that the revised Cybersecurity Model Law was not workable and that various industry groups would vigorously oppose the Cybersecurity Model Law in the states if the NAIC adopted it as written. Despite Chairman Hamm's goal to finalize the Cybersecurity Model Law by the Fall National Meeting, it was not presented to the Executive and Plenary Joint Committee for adoption as an official NAIC model law.

Personal information under the Model Law includes information related to the physical, mental or behavioral health or condition of a consumer, regardless of whether the information amounts to protected health information under the Health Insurance Portability and Accountability Act (HIPAA), in addition to information on the provision of health care to a consumer.

The Cybersecurity Model Law preserves existing private causes of action under state law although it does not authorize any new private causes of action.

On March 7, 2017, the Cyber Security Task Force (EX) held a conference call on version three of the Cybersecurity Model Law. Although the Cybersecurity Model Law appeared significantly revised from the August 2016 version, most representatives from the various trade organizations continued their objections and declared their non-support of the Cybersecurity Model Law as drafted.

Overall, although NAIC is approaching this exercise as a model law, it seems unlikely that the final template will alleviate the inconsistencies between state data security and notification laws that insurers are currently required to navigate. Nevertheless it remains to be seen how the Cybersecurity Model Law will be incongruent with first mover individual states, such as the vastly different New York Department of Financial Services (NYDFS) final regulation on Cybersecurity Requirements For Financial Services Companies (as discussed below).

NAIC Report on the Cybersecurity Insurance Coverage Supplement

In 2015, NAIC created the Cybersecurity and Identity Theft Coverage Supplement (the "Supplement") to the Property and Casualty Annual Statement for 2015, which insurers were

required to file in April 2016. In August 2016, NAIC released a report on the information from the Supplement filed by insurers on the cybersecurity insurance they have provided to businesses and individuals. The report includes the following findings:

- Over 500 insurers provided businesses and individuals with cybersecurity insurance.
- There was a market of over US$1.5 billion in direct written premiums for coverages written as endorsements to commercial and personal policies.
- Standalone cybersecurity insurance was approximately US$515 million in direct written premiums with US$374,000 in direct earned premiums (indicative of a growing market).
- Cybersecurity insurance as a package policy totaled approximately US$933 million in direct written premiums.
- There are a significant number of alien surplus lines insurers writing cybersecurity coverages that are not included in the report since these entities are not required to submit reports for the Supplement.

Standalone Cybersecurity Policies. Other highlights of the report with respect to standalone cybersecurity insurance policies was the dominance of the top 20 insurers with 95.8 percent of the market and the top ten insurers writing 78.7 percent of the total. Loss ratios for standalone cybersecurity insurance varied from zero to over 500 percent, a range that the report attributed to either poor underwriting or simply bad luck in insuring a business that suffers a breach.

Package Policies. Slightly less than half of the insurers reporting on cybersecurity package policies reported no premiums due to the difficulty of breaking out cybersecurity coverage from the overall package. Consequently, NAIC staff extrapolated the total of US$933 million in premiums using the proportionate share of the percentage of insurers that did report cybersecurity premiums.

Identity Theft Coverage. In 2015, insurers wrote 16.6 million package policies including identity theft coverage, making it the most common form of cybersecurity risk. In contrast, there were 496,000 standalone identity theft policies, which totaled US$21.2 million in premium (US$42 per policy). Using the US$42 per identity theft policy premium, NAIC staff calculated the premium of the 16.6 million package policies with identity theft to be US$700 million.

New York Department of Financial Services Cybersecurity Regulation

In September 2016, NYDFS proposed the most far-reaching cybersecurity regulation in the country that would apply to all state-licensed financial services companies, including insurance and reinsurance companies, as well as producers and other intermediaries (Covered Entities). The NYDFS held a public hearing where the industry provided stark criticism of the prosed regulation. The concerns centered around the unintended costs to small companies and producers, which includes individuals, as well as lack of clarity surrounding the complexities of implementing the regulation on insurance industry-specific information sharing systems, for example nonpublic information shared with reinsurance pooling mechanisms and guaranty funds. In response, the NYDFS issued a revised draft of the proposal on December 28, 2016, which incorporated some flexibility for a company to forego a security practice that is unnecessary to contain risk as well as narrowed the types of data that must be protected (Nonpublic Information). In addition, they extended the phase-in to two years and a confidentiality provision to protect information submitted to the NYDFS under the regulation. Another public hearing was held after the revised regulation was released, which revealed that the core issues were not adequately addressed and the criticisms continued. The NYDFS released the final regulation on February 16, 2017, which went into effect on March 1, 2017. The final regulation was largely unchanged from a revised draft that NYDFS circulated on December 28, 2016.

The final regulation imposes all of the key elements of the Federal Financial Institutions Examination Council (FFIEC) Cybersecurity Handbook on Covered Entities. However, the regulation overlooked the contingent, risk-based framework of the FFIEC handbook and added specific frequency requirements for conducting these measures in the handbook, including audits of vendors. Furthermore, it included encryption, data security and 72 hour breach notice requirements to the NYDFS for breaches of a very broad range of data that could simply be used to identify an individual.

The final regulation also adopts a risk assessment requirement and then conditions its substantive security requirements (as opposed to governance requirements) on the conclusions of the risk assessment. This includes, for example, the frequency of cybersecurity reviews and testing and the use of encryption (for which compensating controls may substitute). However, specific requirements like the 72 hour breach notice requirement, continue to apply to Covered Entities, and make no distinction between licensees, regardless of whether the licensees are considered "Critical Infrastructure" under the NIST cybersecurity framework (as discussed above). Large banks, for example, would face the same requirements under the rule as mid-sized insurance companies.

The NYDFS cybersecurity regulation would require Covered Entities to:

- Conduct a periodic Risk Assessment of the entity's Information Systems
- Establish and maintain a cybersecurity program based on the Covered Entity's Risk Assessment and with certain requirements in its design
- Adopt written cybersecurity policies
- Designate a Chief Information Security Officer responsible for implementing, overseeing and enforcing its new cybersecurity program and policy. The CISO must report in writing at least annually to the Covered Entity's board of directors about the entity's cybersecurity program and material cybersecurity risks
- Monitor and conduct penetration testing of the effectiveness of the Covered Entity's cybersecurity program
- Maintain transaction and server logs designed to reconstruct material financial transactions
- Implement a written vendor risk management program, policies and procedures. The policies and procedures must include the third party's policies and procedures for access controls, including its use of multi-factor authentication and encryption
- Implement controls, including encryption, to protect Nonpublic Information held or transmitted by the Covered Entity
- Establish a written incident response plan
- Notify the Superintendent not later than 72 hours after a determination that a Cybersecurity Event that has a reasonable likelihood of materially harming any material part of the normal operations of the Covered Entity has occurred.

Sharing Economy

At the Fall National Meeting, the NAIC adopted a white paper on insurance coverage issues regarding the sharing economy, focusing on home-sharing companies that offer consumers the ability to rent out a personal residence or home for a short duration. Such short-term home rentals present new insurance challenges. The insurance regulators studied the insurance implications of the trend, outlining risks regulators need to understand to help consumers navigate coverage issues. The paper discusses various coverage options for homeowners, unit-owners, dwelling and renters policies. Limitations for each type of coverage are discussed as well as legal restrictions. The paper also focuses on the need for consumer outreach and education regarding these new services.

A number of states have passed laws governing ride-sharing activity, which require certain insurance coverage. For example, New Jersey enacted bipartisan legislation on February 13, 2017, that mandates criminal background checks for drivers, a zero-tolerance policy regarding use of drugs and alcohol and other requirements. The Transportation Network Company Safety and Regulatory Act, established various regulations for companies such as Uber Technologies Inc. and Lyft Inc., which included mandatory insurance. Sponsors of the legislation said that its uniform standards would stabilize the market for so-called transportation network companies in New Jersey and address concerns about safety regulations and confusion about who is responsible for setting and enforcing standards to protect consumers and safeguard customers.

Under the new law, a business, a driver or any combination of the two must maintain primary automobile liability insurance of at least US$1.5 million for death, bodily injury and property damage while the driver is providing a prearranged ride. Representatives for Uber and Lyft reportedly supported the legislation, saying that the bill would ensure access to ride-hailing services across New Jersey. Companies have six months from the bill's effective date to have the New Jersey Attorney General approve the method that the businesses, or a third party designated by the companies, propose to use to conduct criminal background checks for drivers.

Property and Casualty Price Optimization

The Auto Insurance (C/D) Study Group, led by the former Maryland Insurance Commissioner, was created to review issues relating to the affordability of auto insurance for low-income households. Originally, the primary activities of the Study Group were focused on (i) creating a compendium of NAIC resources on the availability and affordability of auto insurance; (ii) offering the compendium information to FIO in response to FIO's April

2014 request for comments on how to define affordability in the context of auto insurance; (iii) creating a data-call template directed at obtaining data that presumably would allow states to measure the impact of certain rating factors/characteristics on low income households; and (iv) the evaluation of certain pricing practices, primarily premium optimization.

The Task Force began drafting a Price Optimization White Paper in early 2015, which analyzes price optimization and its use in insurance ratemaking, with a primary focus on personal lines. The Executive (EX) Committee and Plenary adopted the Price Optimization White Paper at the 2016 Spring National Meeting.

Big Data

AIC consideration of how insurers collect and use data in marketing, rating, underwriting and claims will continue during 2017, but the issue has been escalated from a working group to a dedicated task force. A Big Data (D) Task Force was formed for 2017 by the Market Regulation and Consumer Affairs (D) Committee and charged with: (1) reviewing current regulatory frameworks used to oversee insurers' use of consumer and non-insurance data and recommending changes to model laws as appropriate; (2) proposing a mechanism to provide states with resources that can be shared to conduct a technical analysis of complex models used by insurers for underwriting, rating and claims; and (3) assessing data needs and required tools for regulators to monitor the marketplace and evaluate underwriting, rating, claims and marketing practices.

At the Fall National Meeting, regulators and consumer and industry advocates expounded on two themes during discussion about the Task Force's work plan for 2017. The first theme was whether regulatory changes are needed to address how insurers use consumer data; and the second theme involved finding ways for regulators to have enough resources to understand complex rating models and how data is being used for pricing. The discussions raised basic questions about what insurance is, and how regulators should respond to insurers' use of data for risk classification and pricing. The NAIC Consumer Representative, Birny Birnbaum (Center for Economic Justice), repeated arguments that consumer advocates have made before that Big Data can be used for extreme risk segmentation that does not allow appropriate spreading of risks. Dave Synder (PCI) reiterated an appeal that regulation not stifle innovation by limiting how insurers can use information and technology. Mr. Synder added that the Price Optimization White Paper adopted by the NAIC in 2016 reaffirmed risk-based pricing and the application of the "not inadequate, excessive or unfairly discriminatory" standard for insurance rates, and that socialized non-risk-based pricing is not the answer. Regulators reiterated that they need better tools to understand rating models and to explain rates to consumers who inquire or complain about their premiums.

EUROPEAN REGULATORY AND LEGISLATIVE DEVELOPMENTS

European Union

"Brexit means Brexit"

The UK's vote to leave the EU in June's referendum came as a shock to the global insurance industry. In the months since the referendum, what Brexit means in practice for the insurance industry and even when Brexit will happen, have been unclear. Insurance groups that rely on passporting rights to trade across the UK and the rest of Europe have had to plan for the future against a background of uncertainty.

Shortly after the referendum, the UK government announced that it planned to serve notice under Article 50 of the Lisbon Treaty in March 2017, thereby triggering the two year negotiation period to leave the EU. Following the UK Supreme Court ruling on January 24, 2017, which held that a parliamentary vote is required before the government can serve that notice, the "Brexit Bill" is currently being debated in the UK House of Lords. However this seems unlikely to delay notice beyond March 2017.

The future is now becoming clearer – UK Prime Minister's Lancaster House speech, January 17, 2017

During her speech, Theresa May outlined the government's negotiating objectives for exiting the EU. Most significantly for insurance groups, the UK government will not seek to retain full membership of the EU single market. Mrs. May also said that she wanted to reach an agreement on the UK's future partnership with the EU within the two year period and, as a "cliff edge" was in no one's interest, she would seek a phased process of implementation.

The course and ultimate outcome of the negotiations is hard to predict, but it now seems likely that reciprocal passporting rights, on which groups' European business models depend, will ultimately be lost. They will, therefore, need to have new structures in place for whenever any transitional arrangement expires – or as soon as March 2019 if there is a "cliff edge" Brexit due to no transitional period being agreed.

Those insurance groups which do not already have advanced contingency plans in place should be reviewing their options urgently given that the timing of Brexit remains uncertain. Those groups with advanced contingency plans already in place will need to decide when to start the implementation process. Groups may need to restructure their operations significantly to ensure post-Brexit compliance. This could potentially involve the acquisition of or the establishment and authorization of new insurers in Europe or the UK, re-domiciliations (*e.g.*, by way of a cross border merger or SE transfers) and portfolio transfers:

- UK-based insurers need to consider how best to structure their European operations to continue to provide services in European Economic Area (EEA) States. UK insurers which currently passport into other EEA states will need to obtain additional licenses to carry on business in those EEA states or may consider establishing licensed companies instead. Capital for these entities will need to be posted in the relevant EEA state.
- UK insurers which have underwritten European insurance policies may need to run off that business pre-Brexit or transfer the business by way of Part VII transfer to an EEA authorized insurer pre-Brexit. Therefore, if a UK insurer does not already have an EEA authorized insurer within its group it may need to set up an EEA insurer so that the UK insurer can transfer the business to that EEA carrier.
- EEA insurers which currently passport into the UK will also need to consider how to operate in the UK going forward. It is possible that the UK will allow branches of EEA insurers to be directly authorized in the UK. If not, EEA insurers will need to set up separate insurance companies in the UK. Capital for such branches or companies will need to be posted in the UK.
- EEA insurers which have underwritten UK insurance policies may need to run off that business pre-Brexit or transfer the business under the laws of that EEA state to a UK authorized insurer pre-Brexit. Therefore, if an EEA insurer does not already have a UK authorized insurer within its group it may need to set up a UK insurer so that the EEA insurer can transfer the business to that carrier.

Uncertainty about transitional arrangements means the timing for these reorganizations could be very tight. If Brexit is little more than two years away there could be serious practical difficulties establishing a new compliant structure in time. Authorization as an insurer in an EEA state and portfolio transfer processes can take up to 12 months. Given the number of transfers likely to be implemented during the negotiation period, the timeline for such processes is likely to be significantly longer.

Where Are Insurers Going…

A common feature of many insurance groups' Brexit plans is the need to establish an EEA insurer to underwrite European policies post Brexit and to which the European business of the UK insurer can be transferred pre-Brexit. A number of EEA States are being seriously considered including Ireland, Luxembourg and Malta. Few insurers have publicly announced where they plan to set up their EEA insurer, but Lloyd's of London has disclosed that Malta is not on its list. European regulators, governments and service providers have been active in promoting the merits of their respective jurisdictions to insurers following the referendum, in the hope of attracting business from the UK.

Insurance groups considering where to site a European hub are taking a range of factors into account, including: the approach

and reputation of local regulators; and practical issues like local employment and office costs, availability of talent, the prevalence of English as a business language, how "business-friendly" local employment law is, infrastructure and accessibility and tax issues. A key issue for many is how the chosen hub fits with the existing geographies of their businesses.

Solvency II Equivalency for the UK post Brexit?

Like other EEA jurisdictions, the UK has successfully implemented the EU Solvency II directive. The UK government's current plan is that when the UK finally leaves the EU, the existing body of EU derived law and regulation will remain in place, including Solvency II in as far as it applies to UK insurers. Consideration may be given to whether UK regulation should change post Brexit. This is already being looked at by an influential committee in the UK parliament, the Treasury Select Committee.

In 2017, the Treasury Select Committee held hearings on the impact of Solvency II and the UK insurance and financial services sectors. Commenting on the Committee's activities, the Chairman of the Treasury Committee said: "Brexit provides an opportunity for the UK to assume greater control of insurance regulation." Industry leaders used the hearing held in January to criticize Solvency II. Soon thereafter, in a speech to the Association of British Insurers, the head of insurance supervision of the Bank of England downplayed the need to make immediate changes to the implementation of Solvency II. In February, the Committee questioned the PRA on the impacts of the Solvency II directive and options available to UK upon Brexit. In the hearing, the chief executive of the PRA testified that the insurance companies were overstating the issues regarding Solvency II and that the PRA will continue to improve on Solvency II implementation on the margins as well as address the insurers' complaints that the risk capital element is too high in the current low interest rate environment.

Assuming the UK continues with a regime broadly similar to Solvency II, the UK will have a compelling case to be granted full Solvency II equivalence by the EU. If the UK is granted full equivalency, UK reinsurers will not be required to post collateral to EU cedants and UK insurance subsidiaries of EU insurance groups will be permitted to calculate their solvency for group solvency purposes on the basis of UK requirements. It is also likely that the PRA would be recognized as the group supervisor for EU insurance groups with ultimate holding companies in the UK. Of course, this could be challenged in circumstances where the EU group supervisor considers that group supervision by the PRA would not result in more efficient supervision

However, the timing of any equivalence finding may be a problem for UK (re)insurers and UK headed groups. Unless equivalence is granted from the point Brexit occurs, there is the risk that there will be an interim period during which UK reinsurers could be treated less favorably than EEA reinsurers by EEA state regulators. And, if Brexit negotiations go badly, it is possible that equivalency status will be withheld whatever the merits of the UK's case.

The Future for the London Insurance Markets…

Once the UK's new relationship with Europe is resolved, and whatever that relationship looks like, we think the UK insurance industry will remain a strong global player. The modern insurance industry was born in London. It has more than three centuries of history, and a phenomenal amount of talent, technical and professional support and risk capital to draw on. The UK has a highly-respected regulatory system, Solvency II equivalence is likely to be secured, and the Lloyd's platform's network of international licenses will continue to provide unparalleled access to global insurance markets. In or out of the EU, those fundamentals will endure.

There is likely to be a renewed focus on the relationship with the US, which was central to the London market's development, and existed long before the EU came into being. Differing outlooks of regulators in the EU and the US have caused problems in the past. Resetting UK regulation to align it closer to the US could turn out to the UK's advantage if it helps trans-Atlantic relationships flourish post-Brexit. UK insurers will also no doubt look to develop and grow their business in new markets, as the UK industry has done throughout its history. London is growing and will continue to grow its connections with developing economies and the centers of global growth in Latin America and Asia.

Its resilience and creativity has enabled the London market to deal with shocks and crises in the past. It has traded on through world wars and catastrophic losses and has met evolving sources of competition with vigor. There will be serious issues to confront and the economic, regulatory, legal and political environment for the UK insurance industry may be in flux for some time, but the UK market can be expected to continue to prosper in years to come, albeit probably without the advantages of easy access to European markets that EU membership has brought, and against a different regulatory landscape.

Solvency II Implementation Review

In 2016, the European Commission began the process to review certain elements of Solvency II. In July 2016, the European Commission requested that EIOPA provide advice on two priorities for review of the Solvency II Framework: proportionate and simplified application of Solvency II requirements; and removal of unintended technical inconsistencies (Delegated Regulation). EIOPA took the first step to prepare its technical advice by publishing a Discussion Paper on Review of Specific Items in the Solvency II Delegated Regulation, focusing on the Solvency Capital Requirement (SCR) standard formula in

December 2016. EIOPA intends to develop changes in methods, assumptions and standard procedures and policy changes to ensure a proportionate and technically consistent supervisory regime for (re)insurance undertakings; simplifications in the SCR standard formula; and proportionate application of the requirements. Comments to the discussion paper were due March 3, 2017. EIOPA must submit its advice to the European Commission on October 31, 2017, in advance of the European Commission's review of the standard formula for Solvency II, which is to take place during 2018.

Consumer Protection and Insurance Distribution Directive (IDD)

Protecting the consumer has been on the top of EIOPA, European Commission and IAIS's agenda throughout 2016 and is apparent throughout the provisions of the IDD which came into force at the start of the year on February 20, 2016. Member states have until February 23, 2018 to transpose the IDD into national laws, but it is expected that some (e.g., France) may complete transposition before that deadline. Despite the uncertainty over many aspects of insurance regulation caused by the UK referendum vote to leave the EU, implementation of current legislative plans for the IDD will continue while the UK remains a member of the EU.

Key Provisions of the IDD

The IDD is intended to improve customer protection by changing insurance distribution standards. As set out in our 2015 year-end review, there are a number of key provisions of the IDD which work towards protecting the consumer, notably:

1. *strengthening of pre-contractual information requirements* – customers to be provided with clear information before purchasing products
2. *product oversight and governance requirements* – insurance producers and distributors to implement product monitoring processes in order to ensure that all products meet consumers' interests and needs
3. *prevention of conflicts of interest and remuneration transparency* – remuneration policies applicable to employees of intermediaries, insurers and reinsurers not to conflict with their duty to act in the best interests of customers and
4. *continuous professional training* – employees of insurance companies and intermediaries to have at least 15 hours of professional training per year.

EIOPA Draft Technical Standards

EIOPA has initiated preparatory technical works on the transposition of the IDD and submitted its draft of technical standards in July 2016 for consultation, which ended on October 3, 2016. This paper related to a number of provisions of the IDD including the provisions introduced in points 2 and 3 above. In particular, the paper stressed that manufacturers of insurance products should establish and implement insurance product oversight and governance arrangements that set out appropriate measures and procedures aimed at monitoring and reviewing products for customers. Such arrangements should result in products that meet the needs of a target market, deliver fair outcomes for customers and ensure products are sold to target markets in the appropriate distribution channels. EIOPA's technical advice suggests extending the obligations under the IDD so that insurers and intermediaries have extra requirements, including:

- product testing before bringing a product to market (or before changes to an existing product are introduced)
- ongoing product monitoring once the product is distributed
- the selection of appropriate distribution channels for the product's target market and
- product information to be clear, precise and up to date.

Inputs gathered from the consultation were used by EIOPA to complete its final report to the European Commission, which was submitted on February 7, 2017.

United Kingdom

UK Legislative Developments

2016 saw significant developments in the continuing project to review and update English (and Scottish) insurance law which has been underway since 2006, under the aegis of the English and Scottish Law Commissions.

Insurance Act 2015

In last year's review we highlighted the Insurance Act 2015 (Insurance Act), which was brought into force in the course of the year.

The Insurance Act effects revolutionary changes to English insurance contract law, as it applies to non-consumer insureds, reforming principles which date back to the eighteenth century and beyond. Most of its provisions came into force on August 12, 2016 and apply to policies written subject to English law on or after that date. The Insurance Act applies to both direct insurance and reinsurance. Its broad purpose is to modernize English insurance law, and to some extent rebalance the law in favor of policyholders.

The introduction of the Insurance Act has imposed significant burdens on insurers in the run up to and since its introduction. Insurers have had to develop and then adapt to working with new

underwriting guidelines, policy wordings and proposal forms and claims teams have had to revise their procedures and retrain to work in a new environment of rights and remedies.

The most important changes brought about by the Insurance Act are:

- *Disclosure* – the Insurance Act replaces the duty of utmost good faith with a duty on the insured to "make a fair presentation." The new duty requires insureds to provide information in a reasonably clear and accessible manner to insurers (so the days of data dumping are gone); but full disclosure of material circumstances may not be required. Insureds can comply with the duty by disclosing sufficient information to put a prudent insurer on notice that it needs to make further inquiries.

  Previously an insurer could avoid a policy if the duty of utmost good faith was breached by a failure to properly disclose information that would have been considered material by a prudent insurer. This right has now been restricted. Instead, a range of proportionate remedies are now available depending upon how the insurer would have acted had disclosure of the information in question been properly made.

- *Warranties* – under the Insurance Act, the remedy for a breach of warranty by an insured is that coverage under the policy is suspended. Previously a breach of warranty permanently invalidated the policy. Now, if a breach is rectified, coverage is reinstated. Further, breach of warranties that were intended to reduce the risk of loss of a particular kind or at a particular time or location will no longer give rise to a right to avoid if the breach in question would not have increased the risk of the loss which actually occurred. "Basis clauses," the purpose of which was to turn pre-contract statements automatically into warranties, are also now invalid in policies written after the August 12, 2016 commencement date.

- *Fraudulent claims* – the Insurance Act clarifies the consequences of an insured making a fraudulent claim. Insurers have the option of terminating the contract in the event a fraudulent claim is made, while retaining the premium, and are not liable to pay any of the claim (even parts that are genuine). Termination is effective from the time of the fraudulent act, so insurers remain liable for losses which occur before the fraud. Fraudulent claims are not to be confused with legitimate claims in which a collateral lie is deployed by the insured but the lie is immaterial to the claim as regards insurers' liability and quantum. In those circumstances, the insured may still recover.

- *Contracting out* – aspects of the Insurance Act which relate to consumer insurance are compulsory, but (aside from the prohibition on basis clauses) the Insurance Act can be contracted out of with business insureds. However, any contracting out provisions must be drawn to the insured's attention and must be clear and unambiguous in effect.

Enterprise Act 2016 – Insurers' Liability for Damages for Late Payment

2016 saw other legislative developments. In last year's review we mentioned moves to revise the long standing principle of English law that barred claims for damages for late payment of claims by insurers. This issue was addressed by Parliament in 2016 in the Enterprise Act. This statute made amendments to the Insurance Act, under which insurance contracts will now be subject to an implied term that insurers will pay claims due within a reasonable time. Breach of this implied term will result in insurers being liable to damages. Insureds are required to bring claims for late payment within one year of settlement of the policy claim. These provisions will apply to contracts of insurance or reinsurance entered into on or after May 4, 2017.

The Enterprise Act is intended to penalize bad claims handling by insurers or their third-party claims administrators. Insurers will not breach the implied term simply by refusing to pay the claim if they can show that there were reasonable grounds for disputing it. However, insurers will need to prepare for it coming into force by making sure that practices and procedures are sufficiently robust to avoid them incurring liability of an unreasonable late payment.

Third Parties (Rights Against Insurers) Act 2010 (Third Parties Act)- Rights for Third-Party Claimants

After a delay of six years since it received the Royal assent, the Third Parties Act finally came into force in August 2016. The Third Parties Act, makes it easier for third-party claimants to bring claims directly against a liability insurer, where the insured has become insolvent or otherwise ceased to exist, thereby addressing various problems with previous legislation which dates back to 1930. Most importantly, it is no longer necessary for the claimant to sue the insolvent insured to judgment, or obtain a settlement before he can sue the insurer.

Insurable Interest

With the Insurance Act now in force, and other legislation referred to above in force (or at least enacted with an expected implementation date), much of the decade-long program to update English insurance law has now been completed. Significant reform to English consumer insurance law was effected by the Consumer Insurance (Disclosure and Representations) Act 2012.

However, there are some loose ends – most notably insurable interest, an area where the law is considered unclear and where the Law Commissions have continued to be active. In April 2016 they issued a draft parliamentary bill for consultation. If enacted, the bill would confirm that an insured under a life policy must have an insurable interest in the individual whose life is the subject of the policy, and sets out circumstances where such an interest would be considered to exist. It would also confirm that for non-life insurance the insured must have an insurable interest in the subject matter of the contract, or a reasonable prospect of acquiring such an interest during the term of the contract, and, for a claim to be payable, must have an insurable interest at the time of the insured event. The draft bill also, without defining insurable interest for non-life policies includes a non-exhaustive list of situations where one would exist, (e.g., there will be an insurable interest if the insured will suffer an economic loss on the occurrence of an insured event, arising in the ordinary course of things.)

One reason for the Law Commissions' interest in clarifying the law in this area is the role insurable interest plays in distinguishing parametric insurance policies issued by insurers (e.g., a policy would be triggered by a natural catastrophe to provide financial liquidity quickly to a government so it can deal with an emergency on the ground), from derivative contracts which could have a similar economic effect. If the draft bill does eventually get through Parliament, it will assist in clarifying that parametric policies can be valid as insurance, providing the insured has an economic interest in their subject matter.

Flood Reinsurance

Last year's update reported that legislation had been put in place in the course of 2015 (The Flood Reinsurance (Scheme Funding and Administration) Regulations 2015 (SI 2015/1902) and the Flood Reinsurance (Scheme and Scheme Administrator Designation) Regulations 2015 (SI 2015/1875)) in order to establish the Flood Reinsurance Scheme preferred by the UK government to address the availability and affordability of flood insurance in the UK for residential property. The scheme launched on April 4, 2016 with the initial £20,000,000 costs being funded by the insurance industry itself. An annual levy of £180,000,000 on the industry will follow thereafter. Commercial insurers are offered the opportunity to purchase subsidized reinsurance against flood risk and premiums are capped. The estimate is that over 350,000 households could benefit from the scheme.

Cyber Issues: The PRA's New Plans for Supervising Cyber-insurance Underwriting Risk

Cyber-risk was a hot topic in the UK and European markets throughout 2016, as insurers and corporate policyholders reacted to a number of well-publicized instances of data breaches and hacks, and insurers have continued to develop and market cyber-insurance products.

Insurers' assumption and management of cyber-risk in their underwriting portfolios has become a matter of concern for regulators who are aware that cyber incidents are growing in number and complexity, and affecting a broader range of markets than ever before.

In the UK, the PRA has carried out a thematic review in respect of both affirmative cyber insurance policies (e.g., data breach products) and those that include "silent" cyber-risks (those risks implicit in a policy's cover but not explicitly stated). In November 2016, the PRA published a draft supervisory statement setting out their expectations for the management of cyber underwriting risk. It is expecting insurance firms to analyze their cyber-risk exposure, to invest in cyber expertise and to develop a cyber-risk strategy, with the overall aim of ensuring that suitable products are available and risks are adequately priced.

Findings

The key findings of the PRA's study were set out in its 'Dear CEO' letter issued to all PRA regulated insurers in November 2016. These are:

1. **Silent cyber-risk is material and increasing with time.** This is particularly true in terms of certain lines of insurance, such as aviation and motor, which are experiencing rapid advances in technology (e.g., with complex aviation electronics and autonomous cars). Also, as publicity around cyber-risks grows, it will be harder to claim that "all risks" or other liability policies did not intend to cover cyber-risk unless explicitly excluded.
2. **Most insurers lack a clear strategy and risk appetite.** Most firms have no clear strategy for managing either silent or

affirmative cyber-risk, and exposed industries are not being targeted effectively or provided with adequate products.

3. **Insurer investment in developing cyber expertise is insufficient.** There is a lack of knowledge and expertise within the industry to adequately develop affirmative cyber-risk policies, a fact that is compounded by the insufficient length of claims data and the constantly changing nature of the risks. Insurers are failing to adequately include silent cyber-risk within the pricing or exclusions of broader liability products.

4. **Expertise is needed.** Firms' risk management teams are lacking in the relevant expertise to challenge the business.

5. **Third-party vendor models are at early stage development.** Major catastrophe modelling vendors have expressed their commitment to developing fully probabilistic cyber catastrophe models, but development is at an early stage and it may take a few years before the first versions are available.

The Draft Supervisory Statement

The PRA's draft supervisory statement sets out the PRA's expectations of firms regarding cyber underwriting risks. The central expectation is that firms must be able to identify, quantify and manage affirmative and silent cyber underwriting risk. The PRA then divides its other expectations into three areas:

1. **Silent cyber-risk.** The PRA expects that firms assess and actively manage their insurance products with consideration given to silent cyber-risk exposure, including through:

   a. making adequate capital provisions to deal with the risk

   b. adjusting premiums to reflect the risk and offering explicit cover

   c. introducing robustly worded exclusions and/or

   d. attaching specific cover limits.

2. **Cyber-risk strategy and risk appetite.** The PRA expects all firms that underwrite cyber risks or have an exposure to silent cyber risk to create and maintain clear strategies on the management of these risks, including a clearly articulated risk appetite statement. Information on these strategies will be provided to management, who will be required to sign off on the strategy, to ensure adequate understanding and ownership of cyber-risk coverage at board level.

3. **Cyber expertise.** The PRA expects firms to demonstrate a continued commitment to developing their knowledge of cyber insurance risk. This knowledge should be fully aligned to the level of risk and any growth targets in the field and should exist in business, risk management and audit teams.

The PRA has invited interested parties to submit their views on the proposed supervisory statement, and a final version is likely to be published in the course of 2017. In the meantime, UK insurers should be reviewing policies for exposure to silent cyber-risks (considering whether that risk has been adequately included in pricing or covered in exclusions) and investing in cyber expertise in underwriting, risk management and audit, so that this important developing exposure and business line can be properly understood and managed in accordance with insurers' regulatory obligations.

Germany

Run-off market

The run-off market in Germany has seen recent activity mostly for non-life portfolios and increasingly transactions concerning life portfolios. For non-life business, run-off focuses on policies with long-tail-risks such as motor vehicle liability; employer and employers' liability; and asbestos, pollution and health risks. In the life business a significant number of insurance companies have stopped selling so-called classical life insurance policies with a guaranteed minimum interest rate due to Solvency II implementation and the low interest rate environment. Many insurance companies are now looking to divest these life run-off portfolios by selling portfolios or insurance companies; reinsurance solutions or other forms of alternative risk transfer.

The transfers of portfolios and insurance companies have to be approved by BaFin. Historically, BaFin has been very critical of run-off transactions (particularly life) and has approved only selected transactions after a lengthy and complicated approval process. For example, one company obtained approval for their €2.6 billion life insurance portfolio transfer signed in 2015 only at the end of 2016. Another company recently signed a life insurance run-off deal valued at €3 billion, for which approval is still pending. All in all, the market expects the volume of run-off transactions to double over the next few years.

Supplementary Interest Reserve (Zinszusatzreserve)

In the current low interest rate environment, German life insurance companies, as well as other EEA life insurers, face a particular issue as a result of the Solvency II framework. Insurance companies have to set aside additional risk capital to cover the interest rate risk deriving from classical life insurance policies with a minimum guaranteed interest rate exceeding market interest rates. The amount of funds to be held as supplementary interest reserve increases significantly each year, as long as the overall interest rates remain low. In 2015, additional funds held for the supplementary interest reserve amounted to approximately €10 billion. The funds contributed to the supplementary interest reserve since 2011 were more than €30 billion. In comparison, the total equity of German insurance companies was approximately €15 billion.

Investments

Driven by the low interest rate environment and new opportunities under Solvency II, the German insurance sector is actively looking for alternative types of investments with reasonable and stable long-term returns and low Solvency II risk capital charges. Regardless of the new "freedom of investment" under Solvency II, German insurance companies are still mainly invested in government and (to a lesser extent) corporate bonds. Directly held shares and real estate only account for a very small proportion of total investments (approximately €1.8 trillion). There is a specific focus on infrastructure, renewable energies, real estate hedge funds, private equity and corporate finance, although these investments are currently underrepresented in most portfolios. Infrastructure investments offer attractive stable long-term yields with a low correlation to traditional investments and low volatility compared to stock markets. Renewable energy investments benefit from the favorable regulatory environment in Germany and the declared intention to stop the use of nuclear power leads to an increased need for power generation facilities and the transport infrastructure.

Driven by, among other things, the need to fund the supplementary interest reserve, the real estate market has seen a paradigm shift. For the first time in the current investment cycle, the net investment volume has been negative (at €4.3 billion), meaning that German investors are now focused on selling real estate assets. Nevertheless the demand for German commercial real estate is expected to remain very high due to the inflow of foreign money into the German real estate market.

Invalidity of Netting Provisions under ISDA and Similar Framework Agreements

The German financial market was rattled in 2016 by a (very unexpected) ruling of the German Federal Court of Justice (BGH) which held that the netting provisions in the German framework agreement for derivatives transactions (similar to the ISDA Master Agreement) breached German insolvency law and were not valid. Consequently all German banks and insurance companies that have entered into such ISDA and similar agreements were potentially in breach of applicable Basel III and Solvency II risk mitigation requirements. With a general ruling (which was published surprisingly quickly), BaFin clarified that banks were compelled to treat the netting provisions as valid regardless of the BGH ruling. By the end of 2016, the respective German insolvency law provisions were amended to allow for the ISDA standard netting procedure, putting an end to these discussions.

The Netherlands

In its publication "Vision on the future of the Dutch insurance industry," the Dutch Central Bank (De Nederlandsche Bank, or DNB) predicts that the insurance industry will consistently keep growing in the coming years. More technological, social and economic developments, changing consumer behavior and changing legislation and regulations will impact the insurance industry. This requires additional effort from insurers, supervisory authorities and policymakers in order to continue to safeguard a sustainable, stable, efficient and socially conducive insurance industry.

The Current Status of the Dutch Insurance Market – Continuing Need for Growth, Scale and New Capability

According to the publication of DNB, the total premium volume within the Dutch life and non-life insurance industry amounts to approximately €29 billion a year, which is equal to 4 percent of GDP. The balance sheet total of the life insurance industry amounts to ten times the balance sheet total of the non-life insurance industry. Compared to the balance sheet total of banks and pension funds, the volume of the insurance industry in the Netherlands is relatively limited.

In comparison with other European countries, the Dutch life insurance industry is relatively small. The reason for this is the partially mandatory collective pension accrual in the Netherlands. The premium volume in the life and non-life insurance industry has shrunk significantly over recent years, in particular because of the decrease in the sale of new life insurance products.

The life and non-life insurance industry face difficult market conditions and decreased profitability. In the life insurance industry, profitability and solvency are under pressure, in particular because of the continuing low interest rates. Accordingly, it follows from the results of the stress test executed by the European supervisory authorities that Dutch life insurers are sensitive to interest rate decreases and in particular to a long¬term low interest rate scenario. Also, in the non-life insurance industry, the profitability is low and some non-life insurers are even operating at a loss. The motor insurance industry shows an especially distressed view. These insurers are working on implementing cost savings programs.

In the past 20 years, significant consolidation has occurred in the insurance industry. Increased pressure from legislation and regulations, limited access to the capital market and low interest rates have led to many small and medium sized insurers having been absorbed by larger insurers. Another reason for the consolidation is to control costs and satisfy Solvency II requirements, including the capital resources. More life and non-life insurers within insurance groups and financial conglomerates have merged. Despite the recent consolidation, the insurance industry is still less concentrated than

the banking industry. The five largest life insurers have an aggregate market share of approximately 75 percent, the five largest non-life insurers have a share of approximately 60 percent.

Solvency II

Solvency II is fully implemented into Dutch law and regulation. According to the DNB, Solvency II will change the supervision, the decision-making process and the operational methods of insurers. The DNB has identified the following points as the main changes that result from Solvency II in the Netherlands:

- **RBC requirements.** The capital requirements under Solvency II are based on the underlying risk of an activity. These requirements stimulate insurers to introduce new methods and technologies in order to control risks. Furthermore, the acknowledgement of diversification could lead to further mergers and less market fragmentation. Simultaneously, RBC requirements could make it less attractive to offer products with a guaranteed yield, in favor of products with a variable yield.
- **Market-based valuation of assets and obligations.** Insurers' balance sheets will, under Solvency II, as far as possible, be valued on the basis of market value. Consequently, insurers will be more sensitive to market developments.
- **Governance and risk management.** Solvency II demands a reinforcement of governance and risk management. Insurers should periodically make an assessment of the risks and expectations in various scenarios according to the "Own Risk and Solvency Assessment."
- **External reporting.** More extensive reporting will increase transparency in the industry and will give a better picture of the financial health and risk management of an insurer. In addition, analysts, investors and stakeholders will have a better view of the financial position of the insurer.
- **Harmonization of the regulatory framework.** Solvency II is a significant step towards further harmonization of the regulatory framework within Europe. This harmonization could result in more international activities of insurers. However, differences remain as not all jurisdictions have implemented the transitional arrangements in the same manner. For example, the transitional arrangements concerning the yield curve and technical provisions are not applied in the Netherlands, but they are applied in other European countries (*e.g.*, Germany and the United Kingdom.)

Investment in Technology

According to the DNB, several technological innovations have a large impact on the scope and structure of insurance services. Examples include big data analysis, usage of sensors, the impact of climate change and cyber-risks, as well as ongoing digitalization and automation. All these innovations are of influence in relation to the behavior of insured parties and insurers and have an ambiguous impact on the risks. They reduce the risks that have to be insured, but at the same time create new risks (*e.g.*, cybercrime and extensive product liability.)

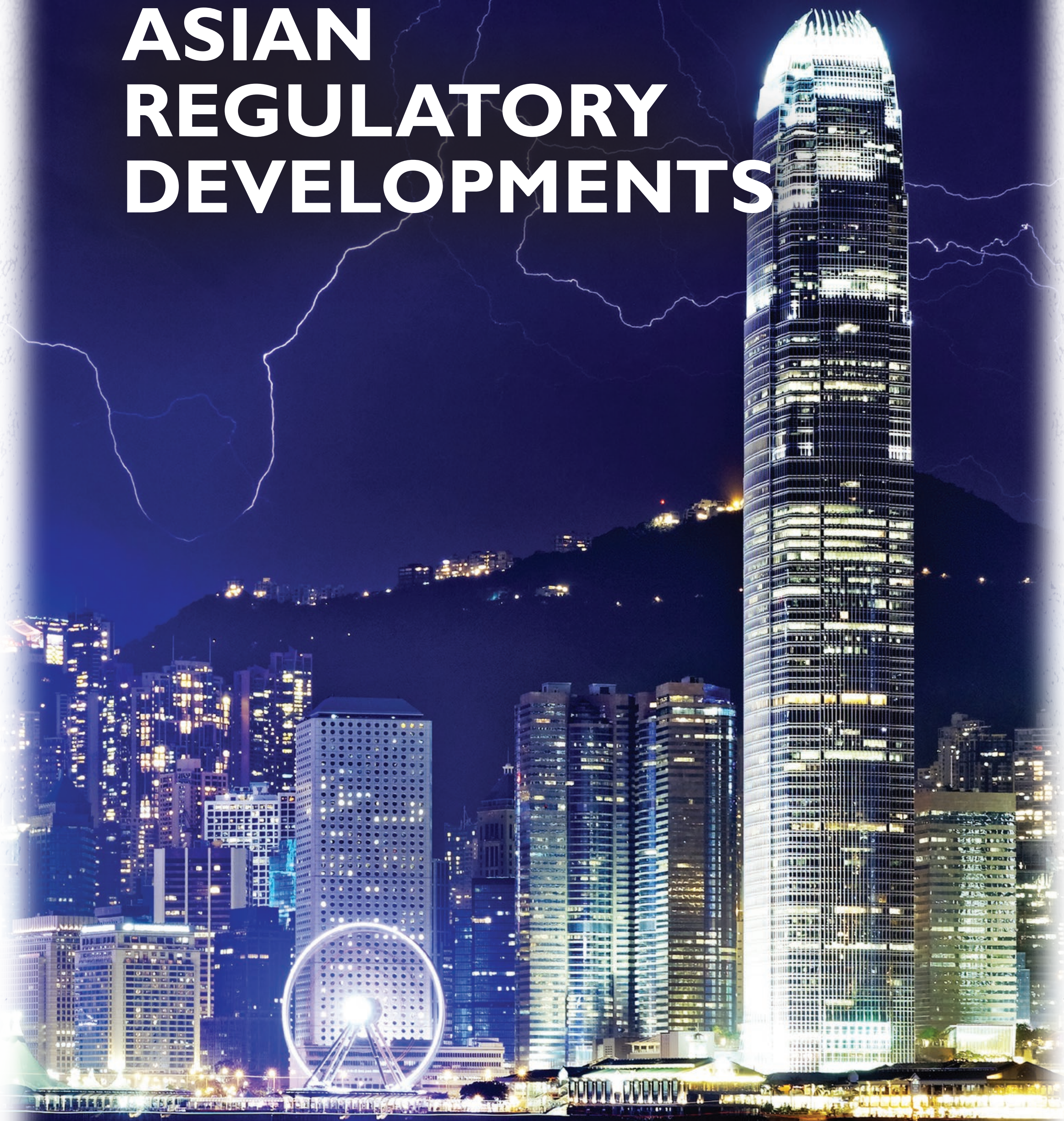
In its publication, the DNB states that technological and social developments create opportunities for newcomers in the insurance market. As a result, competition in the insurance market may increase. Furthermore, social developments and altered customer behavior stimulate new initiatives. With the use of new technologies, newcomers try to take up a specific position in the value chain. The newcomers might be forerunners compared to the established insurers, who usually are not able to innovate as quickly as newcomers.

Technological innovation increases competition in the non-life insurance market. On the non-life insurance market, new technologies result in more extensive information provision for insurers, (*e.g.*, in the framework of accurate risk assessment and effective damage prevention.) The ownership of collected data and the right to use data are crucial for the development and management of insurance products.

Investments in InsurTech are relatively small, but the number of InsurTech companies has increased steadily over the past few years, especially in the United States, Germany and the United Kingdom. Currently in the Dutch insurance market a few InsurTech startups are already active and such startups are targeting the Dutch insurance market to an increasing degree. Some large Dutch insurers also have activities in this area. The Dutch Association of Insurers (Verbond van Verzekeraars) are trying to encourage innovation by introducing an "innovation lab. The DNB expects that successful foreign newcomers or innovations will enter the Dutch insurance market." This could reduce the market share of existing insurers.

Lastly, the DNB emphasizes that the risks posed by innovation and newcomers to the market should be managed adequately, to avoid damaging confidence in the insurance industry. The DNB is concerned about operational risks in relation to automation of processes, risk assessment and claims handling. The legal, operational and reputational risks must be controlled adequately by existing insurers as well as newcomers.

ASIAN REGULATORY DEVELOPMENTS



Hong Kong

The Insurance Companies (Amendment) Ordinance 2015 (update)

In our *2015 Year End Review and Forecast for 2016*, we highlighted the key legislative amendments of this Ordinance on the understanding that such would be fully effective in the year 2016. As earlier pointed out in the 2015 report this comprehensive overhaul of the Hong Kong regulatory regime includes the establishment of an Independent Insurance Authority and bringing the regulation of agents and brokers (currently self -regulated) within the jurisdiction of the new Independent Insurance Authority (IIA). While the legislation is in place, the commencement date has unfortunately been delayed and it is now expected that the earliest date for the Amendment legislation to be effective is mid-2017.

One positive step taken by the Hong Kong Special Administrative Region (HKSAR) government has been the establishment of the Provisional Insurance Authority which is charged with the authority of setting the IIA in motion, recruiting personnel including the CEO and preparing the necessary accommodation and other infrastructure to get the new Authority underway. While this step is encouraging; the work of the Provisional board has been frustratingly slow, resulting in a backlog of insurance license applications and other related regulatory issues.

Despite the delay in the full implementation of the legislation, ultimately it is set to happen as it has long been seen as a vital reform for Hong Kong and an important step towards recognition of Hong Kong as sitting in the top league of global financial centers, properly, efficiently and competently regulated to a high level of integrity and to international standards.

In view and in anticipation of the legislative changes, the current Insurance Authority augmented an amended Guideline (GN10). GN10 set out the minimum standard of corporate governance the Insurance Authority expects of authorized insurers to carry on their business in and from Hong Kong. This is a significant revision to the industry with quite far reaching consequences, both in financial and in resource terms. Apart from the new legislation soon to commence, the current Office of Insurance Commissioner (OIC) has been committed for some time now to bring the Hong Kong regulatory and compliance framework to a level which recognizes the IAIS ICP 8, which comprehensively sets out the standards in respect of risk management and internal corporate controls.

The specific revisions include:

- **Wider application of GN10.** The revised GN10 has increased its scope of application and catches a wider section of the industry. The annual gross premium income threshold for the application of the GN10 to overseas insurers has been reduced to 50 percent and all overseas insurers must comply with applicable corporate governance requirements in their home jurisdictions. The OIC has a discretion in the application of this extension and has given itself the authorization to consider the revision on a case by case basis. It is interesting to note that captives are now "encouraged to adopt" the new GN10 requirements from which they were previously exempt. The financial implications of these revisions could be quite onerous on captives and small insurers despite some allowances being provided on the aggregation of general and long-term business composition.
- **Greater and extended governance.** The revisions impose a far greater corporate governance supervision role on corporations. This comes with an increase in the number of independent non-executive directors (INEDs) (a sliding scale depending on numbers of directors of a company) and extends for the first time to small insurers which need to engage at least one INED irrespective of size. There are new restrictions on who can be engaged as an INED and independence

is the focus. The standard practice of corporations to simply re-employ retiring company officers or investors in the company as an INED will no longer be permitted. Furthermore, the INED must meet the stipulated qualifications (insurance knowledge and so forth) expected of the position holder making the non-executive directorship role far more meaningful and accountable. Such directors need IIA approval.

- **Roles of company officers.** Dual roles of chairman and CEO are no longer recognized as acceptable good governance. Certain key roles of INEDs have been created along with various mandatory committees. The INED is to be the chair of the audit committee and an optional remuneration committee. A mandatory risk committee is to have a majority of INEDs as members. The requirement to form a risk management committee demonstrates a greater focus on internal risk management supervision. The required appointment of a chief risk management officer is just one of the new roles expected in this area. The person's function is to be responsible for the operation of risk management and to provide advice to the board on the corporation's adequacy and effectiveness of the internal policies and material risks to the corporation on a regular basis. What is envisaged here is a dedicated risk manager, trained and qualified in the area of risk management with a proactive approach to the position in order to bring any shortcomings within the corporate operations to the board. What is also a fundamental change is that the chief risk officer has a duty to report information on the area under his supervision to the IIA upon request. Corporations have until January 1, 2018, to become compliant on these risk management requirements. Most other new requirements, however, needed to be in place as of January 1, 2017 (apart from the increase in INEDs, which will be effective on December 31, 2017).

The revised GN10 requires remuneration within the corporation to be reviewed, with the overall goal of rewarding effort within prudent limits. Conflicts of interest must be identified and managed satisfactorily. While not mandatory, a remuneration committee is strongly advised to ensure a balance of achievement and performance with reasonable remuneration within a transparent measurement structure that is not solely focused on volume growth.

Conclusion and Outlook

The ideals that hope to be achieved by the revised GN10, are a step in the right direction to bring the Hong Kong insurance industry in line with its international competitors and produce products and deliver a service within the commitment to achieve international status as a global leader in the provision of Insurance.

Unfortunately, the delay in the establishment of the new IIA has to an extent been caused or at least exacerbated by the dearth of talent in the industry due to past failures to provide sufficient resources for future sustainability and growth. We hope that these lessons have been learned and the new regime will invest in the future to ensure that Hong Kong is once again considered the most vibrant insurance industry in the Asia region.

Thailand

Ministry of Finance Relaxes Restrictions on Foreign Ownership of Insurance Companies Operating in Thailand

On January 18, 2017, the Ministry of Finance (MOF) issued a notification, which liberalized the restrictions concerning the participation and ownership of foreign entities in Thai insurance companies, with immediate effect.

The new measures allow a licensed insurance company (selling both life and non-life insurance) in Thailand to seek permission from the Finance Minister to have foreigners or foreign companies:

- Control more than 49 percent (up to 100 percent) of the shareholding of the insurance company and
- Comprise more than half of the board of the directors of the company.

This is a notable shift, but it is in line with the MOF's growing liberal approach that we have seen in recent years. In early 2015, the Office of Insurance Commission (OIC) was given the discretion to approve foreign entities' applications for permission to control up to 49 percent (compared to the requirement of not less than 25 percent at the time) of the voting shares in an insurance company and more than a quarter, but less than half, of the total number of directors on the board.

Requirements to Apply for Permission

The MOF has issued the following requirements that a foreign entity or shareholder must satisfy to be eligible to apply for permission:

- Be either an insurance company, or one that supports, or is very clearly related to the insurance sector
- Have at least 10 years of experience in the insurance sector
- Be financially stable with a credit rating of at least "A," issued by a respected international agency. If the foreign shareholding company does not have such a rating, its parent must
- Possess clear and methodical business operation and technology transfer plans for the development of its insurance business in Thailand and

- Be sufficiently financially capable to help support, stabilize and develop its Thai insurance company and the insurance industry.

If the Finance Minister grants an application to a foreign entity or shareholder, the insurance company will be required to maintain an available capital of the following:

- At least THB1 billion (circa US$28.3 million) for a non-life insurance provider or
- At least THB4 billion (circa US$113.3 million) for a life insurance provider.

It is important for any potential applicants to consider the capital requirements well in advance before investing time, money and resources in the application process, even though the capital requirements would only apply after the Finance Minister grants permission.

Timeline

- Foreign entities or shareholders that fulfil the criteria may send their applications and associated documents to the OIC for consideration.
- The OIC will evaluate the documents received and may make further information requests.
- Within 90 days after deeming the submissions complete, the OIC will make a recommendation on whether the Finance Minister should grant the application.
- Within 90 days of receiving the OIC's recommendation, the Finance Minister will either grant or deny the application.
- It is difficult to predict the amount of time and resources that applicants may have to devote to obtain permission, given that the MOF has not yet made its application form available.
- The Finance Minister, upon granting an application, may impose additional rules and time conditions at their discretion.
- It may be necessary to obtain the Finance Minister's prior approval, before an insurance company makes any material changes to its shareholding structure.
- At this time, there is no way of determining whether the application process will indeed function efficiently and within the prescribed timelines.

Conclusion and Forecast

When the MOF issued the previous notification allowing increases in foreign ownership rights of insurance companies up to 49 percent, many insurance companies took advantage of this allowance, made applications and successfully received permission to do so from the OIC. While it cannot be guaranteed that the approved increases in foreign ownership rights will carry over to the latest MOF notification, the recent relaxation of foreign ownership rules in Thai insurance companies indicate the MOF's and OIC's increasingly liberal attitudes towards such applications.

There is, however, a key distinction between the 2015 amendments and the new 2017 Regulations. Under the previous 2015 rules, the OIC had discretion to review and grant applications for foreign entities to control up to 49 percent of a Thai insurer. The new 2017 rules however, require the MOF to take on a greater role in the approval process; and the MOF ultimately decides, on the recommendation of the OIC, to approve or decline an application.

Overall, the new 2017 rules represent a step forward for the insurance industry in Thailand as the country further opens its economy to foreign investment. It remains to be seen whether the MOF intends to conduct an intense scrutiny into the recommendations of the OIC, or whether it will merely follow the advice of the OIC.

AUSTRALIA REGULATORY DEVELOPMENTS

Australia

016 saw the continued focus of the corporate regulator, the Australian Securities and Investment Commission (ASIC), on the sale of retail insurance products, particularly in the no-advice context. This focus came at a time of increased interest by the media in relation to the approach taken by life insurers and banks to the handling of life insurance claims. As a result, the ASIC has publicly expressed its concerns and pushed for improvements in insurance company culture to address the risk of inappropriate, unethical or unlawful behavior on the part of a company's management or employees, in addition to other reforms such as intermediary remuneration.

Sale of "Add-on" Insurance

In September 2016, ASIC issued "Report 492: A market that is failing consumers: The sale of add-on insurance through car dealers." ASIC reported a number of findings and recommendations about the sale of what are referred to as "add-on" insurance policies.

Add-on insurance policies are sold at point of sale in addition to the sale of other products or goods. Examples are the sale of consumer credit or payment protection insurance at the time that a consumer loan is arranged, including a loan to acquire a motor vehicle.

In Report 492, ASIC provided a number of suggestions for improvements that insurers should introduce in the sale of these products, including:

- Deliver better value by improving claim ratios. If ratios do not improve ASIC will "consider steps such as public disclosure of claims ratios to increase the visibility of these poor outcomes."
- Reduce commissions and other benefits paid to product distributors and pass on those savings in the form of reduced premiums.
- Redesign sales practices to address behavioral biases and to provide more effectively and timely information to consumer into the sales process.

At this stage there have been no changes to the laws or regulations that apply to the sale of products of this nature.

At this stage there have been no changes to the laws or regulations that apply to the sale of products of this nature; however, there will likely be developments in this area in the year ahead. For example, consultation has commenced in relation to the introduction of laws to regulate product design and distribution obligations. This consultation relates to reforms proposed by the government to introduce a number of measures intended to reduce the risk of consumers acquiring or being mis-sold products that do not meet their needs. These measures include:

- Introduction of a principles-based product design and distribution obligation and
- Amending the law to give the ASIC product intervention power.

Risk Management Systems

Under Australian Prudential Regulation Authority (APRA) prudential standard CPS 220: Risk Management, a general or life insurer must maintain a risk management framework that enables it to appropriately develop and implement strategies, policies, procedures and controls to manage its material risks.

In October 2016, APRA issued an information paper about providing, among other things, an outline of APRA's supervisory priorities in relation to risk culture. Consistent with the thematic focus on culture and ethics, APRA refers in the information paper to the management of "conduct" risk. That is the risk of harmful conduct to investors or policyholders. In this regard, APRA recognizes that the primary responsibility for regulation of insurer conduct falls with ASIC, through its mandate to ensure fair outcomes for customers and investors.

In the paper, APRA sets forth its own mandate with respect to the management of conduct risk, recognizing that as a result of undesirable behaviors and attitudes towards risk taking and risk management, the viability of an APRA-regulated financial institution itself might be threatened. This may in turn jeopardize both the institution's financial obligations to depositors, policyholders or fund members and its financial stability.

APRA recognizes its common area of interest with ASIC and the need for the regulators to work together on risk culture matters. One example given by APRA about such collaboration is where "[ASIC] identifies behavior that produces poor customer outcomes, this can provide useful insights for the prudential regulator as to the organization's broader attitude to risk. In this way, the work of the two agencies, while pursuing their respective mandates, can be mutually supporting."

Based on these statements, the industry should expect further collaboration in the year ahead between regulators in the area of conduct and compliance risk.

Life Insurance Reforms

In October 2016, ASIC released a report on the findings of an industry-wide review of claims handling in the life insurance industry, the focus of the review being to identify systemic concerns that apply either to the industry as a whole or to particular insurers.

The focus of the review was claims practice and claims dispute resolution. However, some focus was given to the contribution of poor sales practices to claim outcomes. ASIC reported that "[t]he insurers' documents we reviewed indicated that there are issues in this area, particularly in terms of complaints from policyholders. As noted earlier, four percent of disputes related specifically to sales practices. High lapse rates may also be an indicator of mis-selling of policies to consumers for whom the cover is not suitable or unaffordable. We will explore this issue as part of our further work on non-advised sales practices."

ASIC noted that it is committed to undertaking further work on life insurance sales practices, with a focus on non-advised sales given the projected growth in this area.

In addition to this, the Corporations Amendment (Life Insurance Remuneration Arrangements) Bill 2016 (Bill) has passed both Houses and will take effect from January 1, 2018. After originally lapsing in April 2016, the Bill was reintroduced late last year with minor changes.

The Bill amends the Corporations Act to remove the exemption against the ban on conflicted remuneration for benefits paid in relation to certain life insurance products.

Conflicted remuneration is defined as a benefit which could reasonably be expected to influence the choice of financial product recommended, or the financial product advice given, to retail clients. The impact of this legislation will be significant as it will introduce level commissions across the industry and the removal of high upfront commissions for life advisors.

The amendments to the Corporations Act also potentially impacts the sale of life insurance products where no advice is provided.

The Bill addresses perceived problems with remuneration practices leading to poor quality life insurance advice for consumers that have been highlighted in several independent reports including a 2014 ASIC Review of life insurance, the industry initiated Trowbridge Review and the Financial System Inquiry.

In response to these reforms, the Financial Services Council has developed a life insurance code of practice that will be effective July 1, 2017. The code includes provisions relating to, among other things, sales practices and advertising practice. The code is mandatory for all members of the Financial Services Council, which includes the majority of participants in the life insurance industry.

Claims Reforms

The regulator sought the removal of the exemption of "insurance claims handling" from the definition of "financial services" in the Corporations Act. ASIC also sought more significant penalties for misconduct in relation to claims practices. The Minister for Financial Services and Revenue confirmed that a proposal is being considered by the ASIC Enforcement Review taskforce.

If the exemption is removed, this would significantly impact claims management services and the obligations that these businesses would need to meet.

The taskforce is due to report to the government in 2017.

New Zealand

Insurance Regulation Updates and Pending Reforms

Several developments in insurance-related legislation progressed during 2016. Of note, the governmental reviews of the Insurance (Prudential Supervision) Act 2010 (IPSA) and the financial advisers regime have moved forward. Changes to the fire service levy, which is calculated by reference to certain insurance contracts, are also pending.

In 2016, the International Monetary Fund (IMF) conducted a comprehensive review of New Zealand's financial system, including an assessment of New Zealand's compliance with the ICPs issued by the IAIS. The report based on the review is expected to be published around April 2017.

Prudential Supervision

Insurers carrying on business in New Zealand must hold a license from, and are supervised by, the Reserve Bank of New Zealand under IPSA. In April 2016, the Reserve Bank announced that it was planning a review of IPSA. The driver behind the review was the desire to ensure that IPSA provides a regime that is "cost-effective, risk-based and promotes the soundness and efficiency of the insurance sector."

The Reserve Bank intends to release an issues paper in Q1 2017. While the scope of the paper is still being finalized, the Reserve Bank has indicated that it will include, amongst other things, the questions of whether additional tools are needed to recognize the diversity of business models in the sector, whether there is scope to apply more generic requirements (as opposed to individually applied requirements) and whether the requirements for overseas insurers adequately balance the goals of recognizing home country regulations with protecting New Zealand policy holders.

It is anticipated that the review will be completed in 2018. Any legislative amendments arising from the review will be introduced to Parliament in 2018 at the earliest.

The Reserve Bank has also signalled that later in 2017 it intends to look at how effectively the Appointed Actuaries are functioning and conduct a thematic review of insurers' compliance with disclosure obligations.

In 2016, the Reserve Bank conducted a review of the operation of life insurance statutory funds, based on submissions made by all of the insurers that are required to operate such statutory funds. While the Reserve Bank identified some issues, such as mingling of statutory fund assets with other assets of the insurer, misdirection of cash flows and inadequate reporting of profit allocation, it was generally satisfied with the level of compliance with the law.

Financial Services Reform

Insurance is a financial product for the purpose of the regime regulating financial advice. In July 2016 the Ministry of Business, Innovation and Employment completed its review of the regime and published its report. The report identified a number of issues with the current system, including that it contains some confusing and misleading terminology, inhibits technological innovation, imposes disproportionate competency and conduct requirements, that conflict of interest situations can result in compromised advice, that the compliance costs incurred by advisers can be disproportionate and that certain parties have misused the Financial Service Providers Register.

The key changes that it recommended, and that the government has agreed to, are intended to simplify the regime. The changes include the following:

- Removing unnecessary complexity by revoking the requirement for personalized advice to be provided by a natural person and changing the way that advice is categorized.
- Establishing more proportionate entry and ongoing regulatory requirements by introducing standard competency and conduct obligations and requiring all advisers to put their customer's interests first.
- Removing the four current adviser designations and replacing them with three new designations – advisers will either be financial advisers, agents or financial advice firms.
- Improving consumer understanding of the regime by using better terminology and providing consumers with simpler but more meaningful disclosure. Advisers will also be required to comply with new client care obligations.
- Establishing a lower-cost, fit-for-purpose licensing system, which will require all advisers to be licensed, with some flexibility built in to recognize the different size and nature of advisers.
- Requiring businesses to have a stronger New Zealand connection in order to be registered on the Financial Service Providers Register. This recommendation is being further refined but it is likely that it will require the financial services provider to be providing financial services to New Zealanders or be in the business of providing financial services (other than back-office administrative services) from New Zealand.

An exposure draft of the Financial Services Legislation Amendment Bill is expected to be released in 2017.

Review of Earthquake Commission Act 1993

New Zealand has a national disaster insurance scheme established by the Earthquake Commission Act 1993. A review of the scheme was announced in 2012 and a discussion paper was released by the government in 2015. The resulting proposals were intended to improve the claims management experience for EQC claimants, particularly during large claims events such as the Canterbury earthquakes. One key proposal was that future EQC claimants would lodge claims with their private insurer rather than with EQC, as is currently the case. Following the Kaikoura earthquake in November 2016, the proposal was reflected in an agreement between EQC and the Insurance Council of New Zealand enabling private insurers to act as EQC's agents for handling EQC claims. The agreement should pave the way for the proposed legislative reform.

Another proposal is to limit the existing EQC land coverage and extend the EQC building coverage to include features of the current EQC land coverage relating to any necessary earth works to repair or rebuild the building or access to it. This would involve raising the cap on cover from US$100,000 to US$200,000.

It was anticipated that an Earthquake Commission Bill would be released in 2016, however the review has taken longer than expected due to the complexity of the issues raised. The bill is now expected to be released in 2017.

Reform of Insurance Contract Law

The Minister of Commerce and Consumer Affairs has made several recommendations to the Economic Development Committee with regard to insurance contracts, including recommendations to consolidate the legislation relating to insurance contracts into a new statute, to codify the policy holder's duty of disclosure and require insurers to warn of the consequences of non-disclosure, to align the remedies for misstatement and non-disclosure and to limit an insurer's rights to avoid an insurance contract. It is expected that this reform will proceed once the review of the EQC Act is completed.

COMMERCIAL AND TRANSACTIONAL ISSUES AND TRENDS

Global Trends in Insurance M&A in 2016 and a Look Ahead

After the record-breaking global M&A activity of 2015 that we reflected on in last year's report, market observers predicted continued momentum into 2016. In no market was this optimism more prevalent than insurance M&A; where increased interest from Asian and South American investors, unprecedented mega-deals – both in terms of strategic consolidation and with non-insurance counterparties – and regulatory driven diversification of risks had put insurance M&A firmly in the spotlight.

However, 2016 was the year that bucked the trend. A series of market destabilizing developments stemmed deal flow. By June, Reuters had reported that 2016 was turning into a "record year for broken deals in global M&A." The insurance M&A market, while no exception with deal volume down by 20 percent, experienced more of a market change than a slowdown; a switch from the mega-deal of 2015 to lower value strategic transactions to optimize capital and profit from previously untapped markets.[1] This trend looks set to continue into 2017, with insurers looking critically at their business focus as well as investing in tools to make the most of an increasingly interdependent global market.

In this section of the Insurance Forecast, we share a number of our observations of the insurance M&A market in 2016, as well as our outlook for the year ahead:

2016 in Brief

M&A activity has cooled but markets remain buoyant. The phenomenon of the insurance megamerger in 2015, which saw 89 deals each with a value exceeding US $1 billion, did not continue into 2016. Deal volume and value of M&A deals were both down in 2016 – with the total value of deals in 2016 estimated at US$55 billion versus US$111 billion in 2015.

Despite this reduction in activity, 2016 played host to a number of notable acquisitions, including: Sompo Holdings' acquisition of Endurance Specialty Holdings (US$6.3 billion); Arch Capital Group's acquisition of United Guaranty Corp (US$3.4 billion); HDFC Standard Life Insurance's acquisition of Max Financial Services-Life Insurance Business (US$3.2 billion); Liberty Mutual's acquisition of Ironshore Inc. (US$3 billion); Phoenix Group's acquisition of Abbey Life (US$1.2 billion); Canada Pension Plan Investment's acquisition of Ascot Underwriting (US$1.1 billion); and Everwin Enterprises' acquisition of Dah Sing Life Assurance (US$1 billion).

Global market conditions, plus various referenda across European states – including, most notably, UK's Brexit, meant that 2016 was a year of uncertainty for the insurance sector, which undoubtedly impacted the M&A deal flow. In addition, industry-specific factors are likely to have played their part in the reduction of deal activity. This is our own experience, having acted on a number of significant transactions that were aborted due to regulatory or commercial complexities, rather than the result of any impact of global market conditions. However, we are expecting such transactions to move ahead in 2017 after some restructuring.

The adoption of Solvency II in Europe has caused insurers to take a more introspective view in 2016. Boards have been required to give additional consideration to their capital strength before facing outward in the market. Furthermore, the exuberant activity of 2015 could be a factor in the tapering performance of 2016, as deal pipelines simply came to a natural halt in the following year, with insurance companies focused on rationalizing legal entities and integrating operations.

Divesting and/or consolidating portfolio specialisms has been key to insurer strategy. 2016 saw many multinational firms with assets in the insurance sector shedding non-core businesses in response to regulatory factors, to free up capital within their group or due to a commercial refocus. We expect restructuring and group simplification to be a prevailing factor behind insurance M&A activity in 2017, which we consider in more detail below.

In one of the top five 2016 deals in the insurance M&A sector, Deutsche Bank sold its Abbey Life Assurances business to Phoenix Group for £935 million. While Deutsche reportedly made a significant pre-tax loss on the sale, it cited simplification and protection of capital position due to new insurance capital requirements as compelling reasons behind the sale. AIG recently announced the sale of its interest in Ascot Underwriting Holdings Ltd, the latest in a long line of divestments it made in 2016 to refocus on its core businesses. Further, AXA completed its divestment of its life assurance and savings business in 2016 to "rebalance the focus of its UK activities towards property, health and asset management,"[2] following separate disposals of SunLife, Embassy, Elevate and Bluefin.

Conversely, Phoenix Group looked to consolidate its closed book life business through the deal with Deutsche Bank and its acquisition of Embassy from AXA.

Insurance linked securities. As predicted in last year's report, the ILS market continues to tempt previously nervous investors away from volatile equity markets with low interest rates and high yield, including those in the UK if the government's promised framework for issuing ILS in the UK goes ahead.

The UK Autumn Statement revealed plans to bring ILS onshore through favorable tax and regulatory treatment and allowing ILS to be issued in London from 2017. Capital in ILS products stood at US$75 billion at the end of June 2016,[3] a market which the UK has so far failed to penetrate.

1. Global Insurance M&A Themes 2016, EY.

2. Paul Evans, Chief Executive Officer, AXA U.K.

3. Aon Benfield.

In general, 2016 was a down year for ILS issuances, at least in the catastrophe bond market. However, there was continued use of so-called "collateralized re" or securities issuances that are exempt from registration under Section 4(a)(2) of the Securities Act of 1933, as amended, which require minimal (and in many cases sub-par) disclosure from a securities liability perspective. Many of these features involve a transformer entity, a Bermuda protected cell company that issues securities to investors and enters into a reinsurance agreement with a sponsor (re)insurer. It is not always clear that these sponsors appreciate their potential securities liability as participating in a sale of securities, or the investor disclosures that would be appropriate from a securities law perspective in these transactions. Some of them seem to view such structures as simple reinsurance without a securities component. Other sponsors, however, have well-defined and highly compliant programs for these types of offerings.

We expect increased issuance in 2017 and perhaps a banner year, at least in the catastrophe bond market. Unlike last year, there are a number of catastrophe bonds maturing in 2017 in excess of 2016 maturities. We also expect continuing engagement of new market entrants, some of which may not be traditional (re)insurers, such as semi-governmental agencies and major corporations with geographically concentrated operations seeking catastrophic cover.

One major development has the been the continued development of credit insurance risk transfer program by Fannie Mae and Freddie Mac, the two government-sponsored enterprises (GSEs) under which they purchase reinsurance on risks of loss on pools of mortgages. Both GSEs also have similar risk transfer programs that utilize credit linked notes instead of reinsurance. This follows the two Bellemeade Re mortgage insurance catastrophe bonds sponsored by AIG. We expect to see continued structured transfer of mortgage risk in 2017.

Looking Ahead To 2017…

The macro-political uncertainties of 2016 will likely continue to have an impact on markets throughout 2017, however, we have reason to be positive about the level of deal activity, even if the deal landscape looks different:

- M&A activity will continue but we expect fewer megadeals globally
- Non insurers remain interested
- Digitization and InsurTech deals will become a greater focus.

M&A Activity and Restructuring Will Continue, But We Expect Fewer Megadeals Globally

As the insurance industry continues to shift its focus from 2015's deluge of megadeals, to consolidating and managing their existing and core businesses, we expect M&A activity in the traditional markets to pick up later in the year as they have a clearer view of the post-Brexit landscape and life under the Trump Administration.

- **UK and Europe:** After a year of Solvency II and as the vision of a post-Brexit Europe becomes clearer once negotiations begin, UK-domiciled insurers will likely become more active. Any initial apprehension caused by Brexit could soon turn to a feeling of optimism, as insurers seek to implement their contingency plans. Whatever the outcome of Brexit negotiations and the timing of the trigger of Article 50, given that many insurers operate throughout Europe on a passporting basis, this is likely to lead to a wave of Brexit-related announcements throughout 2017. Deal volume could increase as a result; instead of focusing on lateral growth through acquisitions, many European insurers will be exploring new operational structures and means of operating their businesses throughout Europe if Britain is to lose the benefit of the current passporting regime. Brexit aside, a number of European insurers or operations are looking carefully at their capital and operational efficiency (Zurich and Generali being just two notable examples); this may lead to some divestments. This work has already begun among some of the top global insurers. As mentioned above, AXA's divestments saw it exit the UK life assurance business altogether.
- **US:** Market conditions across the Atlantic may continue to stutter in light of the uncertainty surrounding the new US Administration. We expect the US to see a slow start to 2017, with reduced M&A activity in the early part of the year, as businesses await the clarification of President Trump's policies on trade and the wider economy. In 2016 we saw M&A activity driven in large part by the type of restructurings mentioned above in terms of the UK and European markets. AIG, resisting activist-investor led pressure to split its group into separate business entities, has been making significant divestments of non-core business. This includes: the disposal of Ascot Underwriting, as mentioned above; the proposal sale of United Guaranty to Arch Capital Group (US$3.4 billion); the sale of AIG Advisor Group to certain investment funds associated with Lightyear Capital LLC; and the sale of certain of its businesses in Asia, including AIG Fuji Life Insurance Company Ltd (Japan) and its shareholding in PICC Property and Casualty Co Ltd (China). We expect to see restructuring by US groups to continue in 2017; Q1 has already seen a number of deals in the intermediary space, with AJ Gallagher announcing a number of deals (including Eagle Insurance Agency, LLC and Hill, Chesson &Woody) , and Marsh's acquisition of J Smith Lanier. Despite the likely effect on deal activity in the early half of the year, the US may well see an uplift as federal policies become clearer over time. Should the Trump Administration move to deregulate the US market in an attempt to drive US growth, it is likely that an increase in deal activity would soon follow.

- **Asia Pacific:** The traditional agency-based Asian market could see a move towards alternative distribution methods, including affinity and direct distributions channels in 2017, reflecting an increasingly tech savvy population with more disposable income and interconnected businesses channels to reach the ultimate consumer. However, in China the partnership between insurers and banks looks to be in troubled waters; Chinese banks have started backing away from banc assurance deals due to regulator criticism (Caixan). Market jitters were rife on January 2, when China Merchants Bank notified its customers by text message that it would halt sales of its "Win-Win #3" banc assurance product due to new regulations. It remains to be seen what the fallout from this move will be, as Chinese insurers take stock of associated losses. One direct impact will be on the available finance for foreign acquisitions, which may affect large scale outward investment by Chinese insurers.

- **East to West:** As we predicted last year, the East to West phenomenon has continued, albeit with some challenges. Asian acquirers continue to show interest in western assets, exemplified by China Oceanwide's continued effort to purchase of Genworth and the acquisition by Sompo Holdings, one of Japan's biggest insurers, of Endurance Specialty Holdings (following its failed bid for Amlin in 2015). We have seen significant deal activity in particular from China, although as investors are continuing to develop relationships with regulators in the more traditional insurance markets, we have also seen a number of proposed deals fail to make it over the line. China's outwards investment trend may also change in 2017 in response to the Chinese government's proposed new restrictions on outbound foreign investment in an effort to curb capital outflows. Meanwhile in Japan, life insurers are likely to continue to pursue M&A opportunities abroad and accumulate foreign bond holdings to improve their investment yields (Fitch). Market observers believe this to continue given an ageing, contracting population and current very low bond yields in Japan (*e.g.*, around 0.5 percent for 20-year JGB[4]).

- **Brazil and LatAm:** After three years of economic downturn in Latin America, the insurance sector managed to remain profitable in 2016 and is expected to continue growing in 2017. Brazil, the largest economy in the region, is expected to overcome the economic challenges faced as a result of recent political uncertainty and allegations of corruption. Notwithstanding the challenging environment in the region last year, AIG agreed the sale of certain Latin American (and European) property-and-casualty insurance operations to Fairfax Financial Holdings Ltd (US$240 million) and AON announced a deal to acquire Admix to enhance its positions in the private health insurance market. The consolidation in the broker sector is expected to continue.

For the insurance sector, bancassurance and distribution deals remain key focus areas for insurers looking to gain market penetration. In 2016 a number of key global insurance groups signified their intentions to grow this market: Zurich reported an increase in capacity in its distribution arrangement with Via Varejo, the largest retailer in Brazil, as well as securing a distribution arrangement with Fast Shop, a premium retailer in the country; AXA sealed a USD 800 million distribution deal with Pernambucanas, one of the largest retailers in Brazil; and Generali closed a bancassurance deal with Banco BMG. Tighter regulations are expected for distribution arrangements going forwards, after reported alleged mis-selling issues in certain distribution arrangements with AES Eletropaulo, the energy provider for the city of São Paulo, and MetLife. Also, the initial public offering of IRB Brasil Re, Brazil's former reinsurance giant, is expected later in 2017 after being delayed due to the economic and political challenges mentioned above.

As the global markets settle, we expect that the long term drivers for market consolidation (such as economies of scale, capital efficiency and deployment and geographical and product footprint) will be the same.

4. *Report: 2017 Outlook: Japanese Life and Non-Life Insurance*, Fitch Ratings.

We reported last year that interest from the non-insurance sector capital is high – private equity, pension funds, overseas capital, increasingly diverse investor base and startup funding. 2016 saw increased activity from non-trade investors and we expect this trend to continue apace in 2017.

The activity is driven in part by strategic investors and acquirers seeking higher returns than are currently available in more traditional markets. Notable moves by non-traditional players include the Carlyle Group's acquisition of the car and home insurance brokerage, AA Ireland (€156 million) and Aqualine Capital's acquisition of online insurance intermediary Simply Business. We have seen similar deal activity in Q1 2017, as non-insurer investor clients look to diversify their portfolios and break into the UK insurance market through acquisitions. As the regulators become more familiar with strategic investors and more comfortable with the impact of such an acquisition on the capital resources of the target group, we expect to see more private equity firms venture into the insurance space. In turn, the strategic acquirer market will likely become more accepting of a tighter regulatory environment when compared with the rewards to be gained – and, in turn, we expect this to drive further interest and deal activity.

Tax Updates

Micro-Captives

On November 1, 2016, the Internal Revenue Service issued Notice 2016-66, 2016-47 I.R.B. 1 (Notice), which identifies certain transactions involving micro-captive insurance companies as "transactions of interest." Under the Notice, persons who participated in, and "material advisors" who made a tax statement with respect to, such transactions after November 2, 2006 must file disclosures with the IRS. The due date for participants and material advisors to report such transactions has been extended to May 1, 2017.

The abuse of micro-captives has been on the IRS's agenda for some time now. In recent years, the IRS audited a number of promoters, managers and clients of micro-captives, and several of those audits have resulted in pending Tax Court cases. In February 2015, the IRS placed certain micro-captive transactions on its "Dirty Dozen" list of tax scams.[5] The Notice represents the next stage in the IRS's fight against what it views to be a potentially abusive transaction and takes aim at micro-captive transactions akin to the one at issue in *Avrahami v. Commissioner*, Docket Nos. 17594-13, 18274-13, a Tax Court case that the industry is closely watching.

The Notice describes a transaction in which a taxpayer and a related party attempt to reduce their aggregate taxable income by entering into purported insurance contracts with a captive insurance company that has net premiums of no more than US$1.2 million (US$2.2 million for taxable years beginning after December 31, 2016). The insured claims a deduction for insurance premiums and the captive elects to be taxed only on investment income under Section 831(b), thereby excluding the payments directly or indirectly received under said insurance contracts from the captive's taxable income. The IRS's concern is that the identified transaction does not have a true insurance purpose.

The purpose of the Notice and the "transaction of interest" designation is to permit the IRS to gather information. The IRS believes that micro-captive transactions have a potential for tax avoidance or evasion, but lacks sufficient information to identify which transactions in particular lack a true insurance purpose. For that reason, the IRS has drafted the Notice broadly to identify as a transaction of interest any micro-captive transaction where the insured or related person owns at least twenty percent (20 percent) of the voting power or value of the captive and either the captive does not pay out a lot in losses or the captive uses its money in a way atypical of normal insurance companies. A micro-captive transaction falls within the scope of the Notice if either (i) the amount of the liabilities incurred by the captive for insured losses and claim administration expenses is less than seventy percent (70 percent) of the premiums earned by the captive less the policyholder dividends payed by the captive; or (ii) the captive made available as financing (or otherwise conveyed, agreed to make available or convey to the insured or a related person) any portion of the payments under the contract, such as through a guarantee, loan or other transfer of the captive's capital.

The IRS lists several indicia that the purpose of a micro-captive transaction is tax avoidance or evasion rather than true insurance, including:

- A promoter markets the transaction and provides continuing services to the captive
- The coverage provided involves an implausible risk, fails to match a business need or risk of the insured, and/or duplicates coverage provided to the insured by an unrelated, commercial insurance company, often with a far smaller premium
- The payments by the insured are determined without an underwriting or actuarial analysis that conforms to insurance industry standards, not made consistently with the schedule in the purported insurance contract, agreed to without comparing the amounts of the payments to payments that would be made under alternative insurance arrangements providing the same or similar coverage and/or significantly exceed the premium prevailing for coverage offered by unrelated, commercial insurance companies for risks with similar loss profiles. If the insured includes multiple entities, the allocation of amounts paid to the captive among the insured

5. IR-2015-19

entities may not reflect the actuarial or economic measure of the risk of each entity

- There are issues with the captive's claims procedures or management. For example, the captive may fail to comply with some or all of the laws or regulations applicable to insurance companies in the jurisdiction in which the captive is chartered; in the jurisdiction(s) in which the captive is subject to regulation because of the nature of its business, or both or
- The captive may not have capital adequate to assume the risks that the purported insurance contract transfers from the insured, may invest its capital in illiquid or speculative assets not usually held by insurance companies and/or may loan or otherwise transfer its capital to the insured, entities affiliated with the insured, the owners of the insured or persons related to the owners.

Persons who enter into transactions of interest under the Notice on or after November 2, 2006 must file disclosure statements with their tax returns or amended tax returns, while both such persons and material advisors who make a tax statement with respect to the identified micro-captive transactions must file disclosures with the Office of Tax Shelter Analysis.[6] For transactions within the scope of the Notice that became a transaction of interest after the filing of a taxpayer's tax return, the deadline for making such disclosures was originally January 30, 2017, but was extended to May 1, 2017.[7]

2016 Private Letter Ruling Article – Insurance or not: Insurance Risk vs. Investment Risk

In early 2016, the IRS published two private letter rulings (PLR 201609008 and PLR 201613016), each of which revoked the federal tax-exempt status under Section 501(c)(15) of the Internal Revenue Code of a captive foreign insurance company that the IRS concluded was not an "insurance company" for federal tax purposes.

In order to qualify as an "insurance company," the primary and predominant activity of the taxpayer must be issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies. According to applicable case law, to be treated as an insurance contract for US federal tax purposes, a policy must contain four elements: (1) risk shifting, (2) risk distribution, (3) insurance in the commonly accepted sense and (4) "insurance risk." Insurance risk covers a fortuitous event or hazard and not merely a timing or investment risk.

In the Rulings, the IRS considered each of these elements and concluded that the primary and predominant business of the respective taxpayers was not insurance since the contracts issued lacked insurance risks and the requisite distribution of risk.

In analyzing whether the risk covered by each of the contracts in the Rulings was an insurance risk, the IRS considered all of the facts and circumstances, including the fact that the purported insurer in the Rulings was a captive insurer. Specifically, when delineating between insurance risk and business or investment risk, the IRS has considered things such as the ordinary activities of a business, the typical activities and obligations of running a business, whether an action covered by a policy is in the control of the insured within a business context, whether the economic risk involved is a market risk in the business environment, whether the insured is required by law to pay for the covered claim, and whether the action at issue is willful or inevitable.

The taxpayers in the Rulings offered rather sophisticated lines of insurance products to affiliated businesses in addition to the more traditional products. For instance, insureds could protect themselves against the costs of suffering a public relations crisis, having to comply with new regulations, and even losing a key customer or major business relationship. The IRS held that

6. The Notice requires detailed information disclosure on IRS Form 8886, Reportable Transaction Disclosure Statement, by participants in transactions with certain micro-captives, and requires that material advisors to any affected micro-captive must disclose certain information on IRS Form 8918, Material Advisor Disclosure Statement.
7. *See* Notice 2017-8, 2017-3 I.R.B. 1.

these contracts protected against "investment risk" and not "insurance risk."

The IRS also concluded that the large concentration of insurance risks in the related insured did not constitute risk distribution and such arrangements were a form of self-insurance (i.e., not insurance for federal tax purposes).

The analyses in the Rulings underscores the fact that the presence of investment or business risk is a significant factor in disqualifying an arrangement as insurance for tax purposes, which can compromise a company's election under Section 501(c)(15).

Significant NY Administrative Guidance

Significant New York State and City Administrative Guidance

On March 10, 2016, In re Stewart's Shops Corporation, an Administrative Law Judge (ALJ) denied Stewart Shop Corporation's (Petitioner) request for redetermination of a deficiency based upon the denial of deductions for payments made to its wholly owned captive insurer (Captive). Petitioner owns and operates convenience stores and gas stations in upstate New York and Vermont. During the years in question Petitioner set up Captive to replace external providers for several lines of coverage and deducted premium payments to Captive from Petitioner's net income. The decision turned on whether Captive was truly an independent insurance company rather than a form of self-insurance. Notably, Petitioner included the Captive in its consolidated tax return. Under NY law, however, the Captive as an insurance company could not be included in the combined return of Petitioner, which included various subsidiaries. Petitioner did not deduct the insurance premiums paid to the Captive and eliminated them as intercompany transactions.

New York imposes a franchise tax on a taxpayer's entire net income (ENI), which "shall be presumably the same as" a taxpayer's taxable income for US federal income tax purposes. Petitioner argued that the word "presumably" allowed for a departure from federal law, but the ALJ found, based on prior NY Court of Appeals decisions, that the use of the term was simply to allow for a claimed inaccuracy in the amount reported on federal returns, and that federal taxable income is the correct starting point to determine ENI. It would appear that the ALJ could have ruled in the NY Tax Department's favor simply by pointing to the fact that no deduction was claimed on the federal consolidated return.

Instead the New York Department of Financial Services set forth the rule for the deduction of insurance premiums to related entities explaining that federal tax law permits deductions for insurance premiums, but amounts placed in reserve as self-insurance are not deductible. Four criteria determine the existence of insurance for federal tax purposes: 1) the arrangement must involve insurable risk; 2) the arrangement must meet commonly accepted notions of insurance; 3) there must be risk shifting (*i.e.*, risk of loss shifted to the insurer); and 4) there must be risk distribution (*i.e.*, the number of independent risks being insured in a pool must be large enough for the law of large numbers to operate).

The ALJ noted that the common thread in prior cases is that payments from a parent to a wholly-owned captive do not qualify as deductible insurance premiums because the arrangement lacks risk shifting and risk distribution. Petitioner's stores were not organized as separate subsidiaries, but were owned and operated directly by Petitioner. As a wholly-owned captive, payments for a covered loss directly affected Petitioner's balance sheet and net worth (and not the balance sheet of one or more subsidiary insureds). According to the ALJ, the pure captive arrangement failed to shift the risk of loss from Petitioner to Captive because reserves were created against possible losses rather than a true shifting of risk. The arrangement also lacked risk distribution because the risk was not spread among Petitioner's various subsidiaries and any loss by the parent was not subject to the premiums of any other entity. As a result, the amounts Petitioner paid to the captive failed to qualify as deductible insurance premiums.

NY Tax Department Advises Foreign Insurance Corporations on Franchise Tax Computation

On June 10, 2016, in TSB-A-16(4)C, New York State's Department of Taxation and Finance responded to Petitions for Advisory Opinions from two unauthorized foreign insurance corporations who write surplus lines policies for property and casualty insurance risks, advising them that their franchise tax must be computed under Tax Law § 1502 and not § 1502-a.

Tax Law § 1501 imposes a franchise tax on insurance corporations, computed under rules provided in § 1502, which calculates the tax based on the highest amount computed under four alternative bases: allocated entire net income, allocated business and investment capital, a prescribed portion of entire net income plus salaries and other compensation of elected or appointed officers and certain stockholders, or a fixed dollar minimum of US$250. Tax Law § 1502(b) imposes an additional tax on subsidiary capital. In 2003, Tax Law § 1502-a replaced these taxes with a tax on total gross premiums, but only for authorized non-life insurance corporations. Because Petitioners are unauthorized non-life insurance corporations, they are still subject to the old tax regime. Petitioners also argued that paying franchise tax would result in double taxation in combination with their liability under Insurance Law § 2118, imposed on gross premiums. The Tax Department held that because the § 1502 taxes are not based on premiums, there is no double taxation.

NYC Tax Appeals Tribunal Finds Subsidiary HMO Must Be Included in Combined GCT Returns

On June 3, 2016, *In re Aetna Inc.*, the New York City Tax Appeals Tribunal reversed an ALJ's ruling finding that an insurance holding company is required to include its NY health maintenance organization (HMO) subsidiary in its combined general tax return because HMOs are not insurers and do not conduct insurance business under NY law. Corporations that would have been subject to the former City Insurance Corporation Tax are exempt from the General Corporation Tax (GCT). Aetna utilizes the independent practice association (IPA) model for its HMO business, in which unrelated physicians form an organization that represents their interests and negotiates the terms and conditions of payment with the HMO, and the physicians see patients other than the HMO's.

The Tribunal reviewed relevant NY Public Health Law (PHL) and Insurance Law statutes, noting that the PHL specifically provides, in relevant part, that "no [HMO] shall include in its name the words 'insurer,' 'casualty,' health and accident' or any words generally regarded as descriptive of the insurance function..." Multiple provisions of the Insurance Law applicable to HMOs distinguish between insurers and HMOs, and between entities doing an "insurance business" and those doing a "[HMO] business." The Tribunal held that "reading those provisions of the Insurance Law in *pari materia* with the GCT enabling legislation makes it clear that HMOs are not exempt 'insurance corporations' within the meaning of the GCT enabling legislation and are, therefore, taxable under the GCT." The Tribunal also cited an Advisory Opinion that ruled an IPA model HMO with facts substantially similar to Aetna was not doing insurance business and was not an insurance corporation taxable under Article 33 of the Tax Law. While not binding, the opinion is the sole written authority directly addressing the taxation of HMOs in New York City.

Recent Reinsurance Legislation: Warner-Neal Foreign Reinsurance Tax Legislation

In September 2016, Senator Mark R. Warner (D-VA), a member of the Senate Finance Committee, and Representative Richard E. Neal (D-MA), a member of the House Ways and Means Committee, introduced legislation (S. 3424 and H.R. 6270) to close what is commonly referred to as the "foreign reinsurance tax loophole." Senator Warner and Congressman Neal claim that the foreign reinsurance tax loophole provides an unfair competitive advantage to foreign-based companies over US-based companies in attracting capital to write US business. The stated intent of the Warner-Neal proposal is to curb erosion of the US corporate income tax base as well as to place all insurers on a level playing field. As of the date of this publication, such legislation remains under committee review.

The foreign reinsurance tax loophole purportedly permits foreign insurance groups to shift income from the US into low or no tax jurisdictions overseas through related-party reinsurance transactions. A foreign-based insurance group commonly will write US business through a domestic entity and subsequently obtain reinsurance from a related foreign entity in a low or no tax jurisdiction, thus enabling the foreign insurance group to reduce its overall tax burden and US tax liability by shifting US reserves and related investment income on those reserves overseas. The Warner-Neal proposal defers the deduction for certain reinsurance premium payments paid to offshore affiliates until the insured event occurs. Foreign groups can avoid this deduction disallowance by electing to be subject to US tax with respect to the premiums and net investment income from affiliate reinsurance of US risk.

The Congressional Budget Office estimates that over the next 10 years, receipts from US corporate income tax will drop by approximately five percent. Since 1996, the amount of reinsurance sent to offshore affiliates increased from US$4 billion in 1996 to US$42 billion in 2014, over 90 percent of which went to affiliates in Bermuda, Switzerland and the Cayman Islands.

Opponents claim that the Warner-Neal proposal will serve as a punitive tax on foreign insurance companies and only succeed in driving up costs of reinsurance with the unintended effect of placing these costs on homeowners and businesses in the form of higher premiums. Other critics of the proposed legislation assert that it would violate the General Agreement on Trade in Services and lead to sanctions from the World Trade Organization.

In our view, broadly characterizing related-party reinsurance transactions as a loophole is over inclusive. The critical factor of insurance that gives rise to revenue is the willingness of the insurer to put capital at risk in the event that there are in fact losses claimed under the insurance. The party whose capital is at risk is rewarded with the premium for writing such policy. In most cases where a US carrier reinsures with a related foreign carrier, it is the related-foreign carrier that assumes the economic underwriting risk; subjecting a US carrier's reinsurance premiums to capitalization is logically inconsistent with the underlying economic arrangement between the parties. Current law already provides adequate safeguards against potentially abusive reinsurance transactions between related parties.

Final Debt-Equity Regulations and the Insurance Industry

In 2016, the Treasury and the US Internal Revenue Service issued proposed, final and temporary regulations under Section 385 of the Internal Revenue Code.[8] These regulations provide rules for the reclassification of certain debt instruments as equity for US federal income tax purposes. The proposed regulations were

8. All "Section" references are to the US Internal Revenue Code.

heavily criticized as abandoning many years of case law principles that looked to the substance of the arrangement – applying a multifactor analysis to distinguish between debt and equity in favor of rigid rules not tailored to the problems and that departed from current rules in ways not contemplated by Congress. The IRS received over 29,000 comments to the proposed regulations, including comments from many insurance and reinsurance groups and trade associations. The main concern for insurers and reinsurers was that the proposed regulations were so broad in scope that they would heavily affect everyday operations.

On October 13, 2016, the Treasury released final and temporary regulations (Final Regulations) under Section 385. The preamble to the Final Regulations discussed in detail many of the comments received by the Treasury and the IRS, including those received from the insurance industry. The Final Regulations significantly narrow and relax the provisions of the proposed regulations with respect to insurance and reinsurance companies and, generally, are more taxpayer-friendly than the proposed regulations. In general, the Final Regulations apply to debt instruments issued by a domestic corporation, including foreign insurance controlled foreign corporations that elect to be treated as domestic corporations pursuant to Section 953(d) of the Code and to members of its "expanded group."[9]

Exemption for Foreign Issuers

The Final Regulations reserve on the application of the debt-equity rules to debt issued by foreign corporations, including foreign insurance groups; holding companies; foreign insurance; and reinsurance companies, and foreign service company affiliates. This means that the regulations are not applicable to debt instruments where the issuer is a foreign corporation.

Exception for Regulated Insurance Companies

To address the comments from the insurance industry that insurance companies are already heavily regulated, the Final Regulations provide an exception for regulated insurance companies from the application of certain debt recharacterization rules. The Treasury and the IRS acknowledged in the preamble to the Final Regulations that regulated insurance companies' ability to issue debt is already restricted by various state regulators.

To qualify as a "regulated insurance company," a company must be:

- subject to taxation under Subchapter L of the Code
- domiciled or organized in one of the states or the District of Columbia
- regulated by one or more states or the District of Columbia and
- engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance or annuity contracts with persons other than related persons.

It should be noted that the regulated insurance company exception is rather narrow in scope. For example, it does not cover Section 953(d) companies, captive insurance and reinsurance companies as well as non-insurance members of insurance company groups, such as holding and service companies. The Treasury and the IRS believe that such companies are not subject to the same level of oversight and regulation as regulated insurance companies.

Application of Re-characterization Rules

If a domestic insurance company (or a member of the insurance company group) that does not qualify as a regulated insurance company under the Final Regulations issues debt to a member of its expanded group, the recharacterization rules will be applicable to such debt instrument. Under a "general rule," a debt instrument issued to a member of the issuer's expanded group is recharacterized as stock if it is issued in a distribution, in an acquisition of stock of an expanded group member or in exchange for property in an asset reorganization (a "distribution or acquisition"). Under the so-called "funding rule" debt issued to an expanded group member is recharacterized as stock to the extent of a distribution of property by the issuer to a member of its expanded group, or an acquisition by the issuer of stock of a member of its expanded group, during the 36 months preceding or following the issuance of the debt instrument that funds a distribution or acquisition. However, a debt instrument will not be treated as stock under the re-characterization rules to the extent of the so called "threshold exception." The threshold exception applies to exclude from re-characterization up to US$50 million in debt instruments that would otherwise be recharacterized.

Application of Documentation Rules to Insurers and Reinsurers

The Final Regulations also significantly relaxed the so-called "documentation rules," which require compliance with certain documentation and record keeping requirements in connection with debt instruments issued to members of the issuer's expanded group. First, the documentation rules only apply if (i) the stock of any member of the expanded group is publicly traded; (ii) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding US$100 million; or (iii) the expanded group's financial results are reported on financial statements that reflect annual total revenue exceeding US$50 million. Second, the documentation rules apply only to debt instruments issued (or

9. With several modifications, the term expanded group is defined by reference to the definition of an affiliated group under Section 1504(a) the members of which may file a consolidated return

deemed issued) after January 1, 2018. Third, documentation is required to be completed as of the due date of the issuer's tax returns, including extensions. If a company fails to comply with documentation requirements for related-party debt, such debt may be treated as equity by the IRS.

With respect to insurance and reinsurance companies, some comments on the proposed regulations asked for an ordinary course exception from the documentation rules applicable to all payments on insurance contracts, funds-withheld arrangements in connection with reinsurance, funds-withheld reinsurance and surplus notes. Although the Final Regulations do not provide an explicit exemption for such instruments, the preamble in the Final Regulation states that reinsurance and funds-withheld insurance arrangements are typically not debt in form. Therefore, the Treasury and the IRS did not see a need to issue additional clarifications because such instruments are outside of the scope of the Final Regulations.

In addition, some commenters were concerned that surplus notes issued by regulated insurance companies may not satisfy the documentation rules because the issuer of a surplus note typically does not have an unconditional obligation to repay a sum certain. The Final Regulations provide an exception from the documentation rule for surplus notes issued by regulated insurance companies if, at the time of issuance, it is expected that the surplus note will be paid in accordance with its terms and proper documentation is produced and maintained to support such expectation.

Although the Final Regulations do not provide a complete exemption from compliance to the insurance and reinsurance industry, the scope of the Final Regulations has been significantly narrowed. As a result, it is expected that the Final Regulations will apply to fewer insurance and reinsurance companies. The Treasury and the IRS are still assessing application of the rules to certain issuers and instruments, so there is still significant amount of uncertainty. Finally, the potential tax reform under the Trump Administration puts the fate of the Final Regulations in question.

Antitrust Issues

International

In international insurance antitrust news, the most significant development was the European Commission's decision not to renew the Insurance Block Exemption Regulation (IBER) that is set to expire March 31, 2017.

The exemption is narrowly restricted and covers only agreements between insurers: (1) to exchange information for joint compilations, tables and studies (sharing of actuarial data); and (2) to jointly cover certain types of risk in co-insurance or re-insurance pools. However, the EC position is that this exemption is essentially redundant and should not be renewed.

The EC has been reviewing the IBER for three years, has communicated with all stakeholders and prepared several reports. Among the factors considered by the EC are the following elements:

1. "More competitive" and "less restrictive" ways of co-underwriting risks have emerged in the marketplace, such as broker-led or insurance-line slips
2. The number of active insurance pools was "significantly lower" than expected
3. The spreading of risk does produce pro-competitive efficiencies but insurance is not the only industry that involves the spreading of risk, and the exemption discriminated against similar industries
4. Many insurance-industry stakeholders, asked to detail the impact of non-renewal, did not bother to do so but instead relied on generalized claims that non-renewal would chill legitimate coordination, create uncertain legal risk regarding information exchanges, cause insurers to build up higher reserves (presumably reflected in higher rates), impose higher compliance costs and ultimately harm consumers.

The Commission report essentially concluded that all these factors favored non-renewal. In fact, the EC data suggested that only 46 known pools were in operation, and at least some of those exceeded the market share safe harbors, so they were not actually protected under the IBER after all, and needed to do their own antitrust self-analysis to make sure their agreements complied with the law. (This was particularly true of nuclear pools.)

The EC's conclusion was that any legitimate joint venture or cooperation activity would be protected by the normal rules governing agreements between competitors, as expressed in the Horizontal Guidelines issued by the EC. These Guidelines explain how parties to a horizontal agreement must self-assess their agreements on a case-by-case basis to determine whether they could produce adverse effects in the market.

In December 2016, the Commission issued a release and Impact Assessment Report, confirming non-renewal. The release noted that the IBER was "less and less used in practice," and that its non-renewal did not make any conduct illegal. Instead, cooperating insurers would need to do their own antitrust analysis to make sure they were on safe ground, just as cooperation agreements in other industries. The release concluded that, "following the expiry, the Commission will continue to monitor developments in the market to evaluate how insurers adapt to the change."

It is worth noting that many of the EC's reports over the last three years observed that some insurance companies did not correctly define their markets, did not correctly perform their safe harbor analyses under the IBER or did not perform any analysis at all. The EC's decision to let the IBER lapse means that insurers should be more alert to the need to do an antitrust analysis of their cooperative agreements. If they are unclear about the nature of their markets, how to measure market shares or the general legal tests involved, they should consider getting expert antitrust advice.

United States

McCarran-Ferguson . . . Yet Again

No antitrust insurance summary would be complete without mentioning recurrent attempts to repeal the McCarran-Ferguson Act.

The McCarran-Ferguson Act was passed in 1945 and has generated controversy ever since. Over the last 10 years, we have seen a variety of repeal attempts, most focused on repealing the exemption for healthcare insurers. One healthcare repeal bill actually did pass the House of representatives in 2010 but failed to become law. In 2016, there were five separate repeal bills, and these bills are back again as part of the heated debate over healthcare in the United States.

The McCarran-Ferguson Act provides an exemption from federal antitrust law, but that is restricted to the "business of insurance" and applies only under certain conditions. "Business of insurance" is generally understood to mean activities that have a substantial connection to the spreading and the underwriting of risk. The McCarran-Ferguson exemption does not cover or exempt the various other businesses or activities of insurance companies, and major cases have been brought against insurers in federal courts for insurance-related activities that were outside pure "spreading of risk" activities.

But that does not mean that even the "business of insurance" is exempt from all antitrust laws. In many states, local antitrust law applies to these activities. In fact, major national antitrust cases, including class actions, have been brought against insurers in state courts.

As a result, while McCarran-Ferguson repeal may sound politically attractive to some, it is not really clear if it would make any practical difference. Even now, insurers need to have an active antitrust compliance program.

Mergers and the Insurance Industry: The Two Hot Healthcare Mergers in 2017

By the second week in February 2017, the Department of Justice had already blocked two huge healthcare mergers that were supposed to close in 2017, demonstrating continued aggressive enforcement of antitrust law in concentrated markets, and in particular healthcare.

The two announced mergers were the US$48 billion Anthem-Cigna (combining the second and fourth largest health insurers) and the US$37 billion Aetna-Humana (combining the third and fifth largest health insurers). UnitedHealthcare, now the largest, would have remained unaffected, but reduced to second place.

The Department of Justice challenged both mergers, noting that if they went through, they "would leave much of the multitrillion-dollar health insurance industry in the hands of three mammoth insurance companies." As in all mergers, the plaintiff (government or private) does not have to prove that the merger will definitely harm competition. It is enough to prove that there is a reasonable probability that it would substantially lessen competition.

For context in the health insurance market, in the last few years, there have been five leading health insurers, each of whose scale was vastly larger than any other competitor. This group was called the "Big 5." In 2015, merger plans were announced that involved

four of the five. Had those mergers gone through, the "Big 5" would have been reduced to the even "Bigger 3."

Health insurance companies have been arguing for years that the structural changes in national healthcare policy under "Obamacare" heightened the need for integration, efficiencies and economies of scale that, they contend, can be achieved only through integration. Many have argued that the national healthcare policy (encouraging integration and economies of scale) is in direct confrontation with antitrust policy (that regards high concentration levels as highly suspect, if not damaging to competition).

The Department of Justice sued to halt both mergers. On January 23, 2017, one federal judge blocked the Aetna-Humana merger, and on February 8, another federal judge blocked the Anthem-Cigna merger. In both cases, the judges concluded that the mergers would increase concentration and substantially lessen competition, although they involved different markets. The Aetna-Humana merger decision focused on the Medicare Advantage market and the extent to which it competed with Medicare, while the Anthem-Cigna decision concentrated on sales to large "national accounts."

The Aetna-Humana transaction had a US$1 billion breakup fee while Anthem-Cigna had a US$1.85 billion breakup fee. Anthem has already filed a request for an expedited appeal. By Valentine's Day 2017, Aetna and Humana announced that they terminated their agreement, with Aetna committed to paying breakup fees to both Humana and to another healthcare company that was to buy some to-be-divested assets; and Cigna announced plans to terminate the merger (although Anthem did not appear to accept Cigna's announcement of termination.)

While these decisions may not mean the end of health insurance company mergers, they may curtail any more merger activity within the Big 5. Some speculate whether the new Administration's healthcare policy might allow some merger activity in that group, with possibly the option of effective divestitures (meaning that the buyers of the divested operations would have to demonstrate they were actually capable of generating aggressive competition at pre-merger levels).

At the same time, local and regional healthcare mergers are candidates for possible synergistic mergers, building strength and the potential of economies of scale through integration. But every potential merger, large or small, needs to be studied carefully for its potential impact on the markets it actually serves. (Please see the next section for strategic issues in merger considerations.)

Strategic Points for Companies that May Merge

Government merger enforcement activity continues to be aggressive, with more transactions in more industries being challenged. This includes transactions below the current Hart-Scott-Rodino US$80.8 million base-level threshold. (There are four other higher notification levels as well, including acquisition of control of the target.)

It is important to remember that the Hart-Scott-Rodino Act is simply a transaction reporting statute for transactions of at least US$80.8 million. But every transaction, no matter what size, can be challenged and prohibited if there is a reasonable probability that it could substantially lessen competition. Even transactions below the US$80.8 million reporting level are subject to this test, and there have been many cases where the government has challenged and even litigated transactions below the threshold. In one notable case, the Department of Justice actually litigated a merger whose value was only US$3.1 million.

The Hart-Scott-Rodino Annual Report for Fiscal Year 2015 (issued August 2016 by the two antitrust agencies) reported 78 mergers in the insurance industry, up from 61 the previous year. Of these, two transactions received "second requests" (an extensive demand for more information), *i.e.*, the two healthcare mergers, Anthem-Cigna and Aetna-Humana.

As we pointed out last year, market concentration is one of the key factors affecting whether a merger is likely to be investigated or challenged, and we do not anticipate that priority changing very much under the Trump Administration. There are many insurance markets that are unconcentrated, and mergers in those markets are unlikely to be problematic.

A merger review can involves a number of factors. However, five factors predominate.

First, a major factor in many merger challenges is product market definition, which obviously can affect whether a market is seen to be concentrated or not. Merger parties always have their own vision of what their product market is and what their competing products are. But the government often challenges the parties' claims with either an expanded market (by defining "cluster markets," or groups of products lumped together) or a narrowed market (by refusing to recognize competing products, as for example in the Humana-Aetna merger, where the government won its argument that "Original Medicare" did not compete with "Medicare Advantage").

Some markets, such as health insurance, are becoming increasingly concentrated, and mergers in those markets are likely to generate regulatory interest at a minimum. This is true even though federal policy, expressed in the ACA, would seem to support the efficiencies and economies of scale that come from integration. The Anthem-Cigna and Aetna-Humana deals are two recent examples of large health insurance merger transactions that have triggered Congressional investigations and litigation, with accusations that the mergers would be a threat to consumers and to competition.

Second, aside from product market issues, there is often a dispute about the geographic market. The test is not where buyers could hypothetically go for alternatives, but rather where they are likely to go as a practical matter, demonstrated by convincing evidence. This is particularly relevant to transactions in healthcare insurance, where courts have narrowed the competitive arena to cities or counties, but have excluded destinations that involve more significant travel.

Third, a critical factor in any potential merger is whether a competitor is considered either a "maverick" (a company that threatens to disrupt existing competitive practices) or a company that has some new or innovative product. The government has brought a number of recent merger challenges based on one of these two theories. We do not expect this approach to change under the new Administration.

Fourth, another important consideration in merger preparation is to consider what a company's internal, ordinary-course-of-business documents have said about competition. A number of prominent mergers have failed because parties made claims in their merger clearance proceedings that were completely undermined by their own contradictory, internal, ordinary-course documents. When a merger is announced, many companies issue internal memoranda reminding their employees about the need to describe the competitive impact of the transaction accurately and objectively. That is good advice, but it cannot undue inaccurate and contradictory claims that have already been in ordinary-course documents. Companies should have ongoing compliance programs that require all internal competitive documents to describe markets and competition in an accurate and objective way.

Fifth, those considering mergers in sensitive markets should be prepared for a rigorous econometric analysis as part of the antitrust clearance process. In any event, anyone thinking of a possible merger in any market should consult with antitrust counsel before any analysis or documentation begins.

CONCLUSION AND FORECAST

The insurance industry's forte is managing unexpected events. Even with that core competence, however, most industry leaders were caught by surprise at some of the major political developments last year. Beyond the unexpected, 2016 saw the less surprising but highly significant continuation of challenging commercial conditions – including persistent low interest rates, excess capital and, in many lines, softening rates and modest, if any, increase in gross written premium.

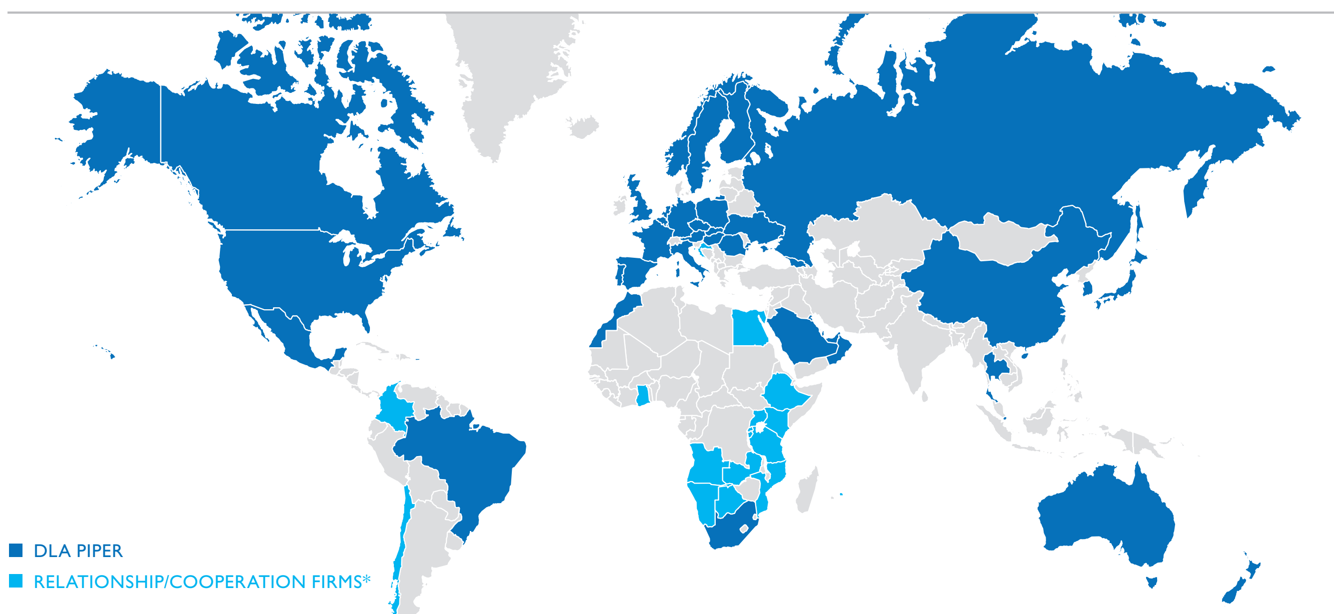
These challenging developments played out, and are playing out, against a backdrop of ongoing changes in regulatory requirements, regulatory organizations and important regulatory relationships. This has created uncertainty and has driven up costs, as insurers consider future licensing/ regulatory requirements, seek to meet more stringent capital and compliance costs, all of which are weighing down insurers at a time when they need to be leaner and meaner.

As we look forward to 2017 and beyond, we expect:

- A continuing effort by many global insurance groups to restructure their operations in response to Solvency II regulatory requirements, anticipated Brexit implications and related developments. This will include disposal of lines of business or business units that do not meet management or shareholder profitability requirements.
- Continued M & A activity as insures seek topline growth, diversification of risk and new business opportunities. Financial investors in the industry may also seek to exit via sales.
- Increased activity and investment in InsurTech, as insurers seek to use technology to support new product offerings, improve internal operations and customer service and as disrupters continue to try and introduce game changers to the industry.
- Increased attention to legacy business and capital/ reinsurance strategies surrounding it.
- Significant further evolution in the regulatory standards and regulatory structures applicable to insurers. In particular, the regulatory relationship between the EU and US, the UK and the EU, the UK and the US will all change in light of further Solvency II implementation, Brexit and the Trump Administration's overall approach to global engagement and cooperation. Changes in regulatory relationships will also be seen in other areas of the world as regulatory rules and rulers change. In the US, it will be important to watch the ongoing tensions between federal and state regulatory forces.
- New business opportunities will emerge, as insures respond to emerging new risks and existing uninsured risks – particularly the gap between economic loss and insured loss from natural and manmade catastrophes.

As evidenced by the trends and developments touched upon in this report, there are multiple and powerful forces driving the fortunes and prospects of the insurance industry. From major political changes, to macro-economic developments, to new legal and regulatory requirements to new or closing business opportunities, 2017 will undoubtedly be a challenging year for the industry. Strength, nimbleness and boldness will likely separate winners and losers.

OUR GLOBAL PRESENCE



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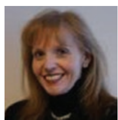

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