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"Insurance Company Owned Life Insurance from a Regulatory Perspective"

True or False Questions — Submit Answers Online

1. One of the primary reasons insurance companies purchase ICOLI is that the cash value grows tax-free within the policy if held until the death of the insured person.
2. There are two basic types of ICOLI products: whole life and term life.
3. ICOLI is accounted for as non-admitted asset pursuant to SSAP 4.
4. If the insurance carrier offering the ICOLI product has a problem, the insurance company can always exchange out of the ICOLI product to a different carrier tax-free under the Internal Revenue Code.
5. The regulator should review the A.M. Best, S&P, Fitch, and Moody's ratings of the insurance carrier offering the ICOLI product, as this is the insurance company's ultimate investment risk.

"Surplus Lines Profit from Underwriting Discipline and Core Competencies"

True or False Questions — Submit Answers Online

1. Surplus lines carriers have enjoyed three consecutive years of underwriting profit fueled by, among others, a growth in premium levels and improved cash flow.
2. Over the past two years, favorable loss reserve development has resulted in composite loss ratio reductions for Domestic Professional Surplus Lines Companies.
3. Under the Non-admitted and Reinsurance Reform Act of 2010, 47 jurisdictions in the U.S. will retain 100% of the taxes they collect as the home state of the insured for surplus lines placements.
4. The largest number of surplus lines carrier financial impairments was caused by problems with the carriers' affiliates and highlight the extent to which poor management of parent companies can impact surplus lines affiliates.
5. When coverage cannot be placed in the admitted market, managing general agents are normally authorized to underwrite and bid coverage on behalf of the surplus lines company

CRE READING PROGRAM QUESTIONS

All quizzes MUST be taken online

(continued)

“Fraud if you have not considered it, you probably missed it!”

True or False Questions — Submit Answers Online

1. Fraudulent activities can be prevented by intrusion detection systems and/or other safeguards.
2. Fraud does not factor in cyber related activities.
3. All critical risks for a company can be impacted by the existence of fraud.
4. Fraud has no potential impact on a company’s relative competitive position.
5. Although it is not considered possible to be able to eliminate all frauds, effective diligence efforts can help to mitigate the potential financial impact of fraud.

NAIC Summer Meeting Notes

True or False Questions — Submit Answers Online

1. The Financial Condition Committee approved a proposal to require mandatory audits of TPAs and MGAs that are used by insurers.
2. The NAIC/AICPA working Group adopted a guidance paper outlining best practices suggestions for regulators to more effectively access audit working papers.
3. The Financial Regulations Standards and Accreditation Committee adopted revisions to the Accreditation Preamble which will make all captive insurance companies subject to the accreditation standards effective January 16, 2016.
4. As of the Summer National Meeting, the Principles-Based Reserving Implementation Task Force reported that the required minimum of 42 states representing 75 percent of direct U.S. life premiums had adopted the principles-based reserving requirements and therefore the PBR Valuation Manual is effective immediately.
5. Despite the adoption by the Blanks Working Group of a proposal to add a Terrorism Risk Insurance Supplement to the 2015 Annual Statement, 2015 data related to terrorism risk will be collected via a data call and not via the annual statement filings.

Insurance Company Owned Life Insurance from a Regulatory Perspective

By **A. Gregory Finkell, JD**
Miles Hopkins, CPA
and
John H. Milne, JD, LLM
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The best source of information on ICOLI holdings of insurance companies is from the 2014 SNL Financial Data, the most recent data available. Based on the 2014 data, approximately 128 property/casualty insurance companies and 72 life insurance companies reported holding ICOLI. The average ICOLI held by property/casualty insurance companies was 5.1% of surplus and for life companies it was 15.0% of surplus.

Why do insurers own ICOLI?

Insurance company owned life insurance offers many advantages for insurance companies that investment products do not. Unless the alternative minimum tax applies, the cash value grows tax-free within the policy if held until the death of the insured, the death benefit also provides a tax-free return and, under applicable accounting rules, the growth in cash value is recorded as "aggregate write-ins for miscellaneous income."

With general account ICOLI products, the cash value of the policy is not adversely impacted when interest rates rise, unlike a bond, where principal may decline. The carrier simply resets the crediting rate (although there may be some time lag due to the duration of the carrier's underlying investment portfolio). Also, with the guaranteed minimum crediting rates and expenses, which are typical with some general account products, there are cash value floors. Finally, the ICOLI product qualifies for favorable risk weighting when calculating capital requirements.

What is ICOLI?

ICOLI is a specially designed, institutionally priced life insurance product. It is typically funded with a single premium. The insurance company is the owner and beneficiary of the policy. The life insurance is placed on a select group of officers and, in some cases, members of the Board. The product can be issued with limited medical underwriting or, if ten or more employee lives are insured, on a guaranteed issue basis without any medical exams. The cash value of the ICOLI generally equals or exceeds the initial premium paid from day one.

Types of ICOLI Products

There are two basic types of ICOLI products: whole life and universal life. This article, however, should not be perceived as promoting any particular insurance carrier or type of ICOLI product.

A whole life product is the more traditional form of life insurance. It is a bundled product and is actuarially designed such that, based upon a set premium payment, the product is guaranteed to provide permanent life insurance protection.

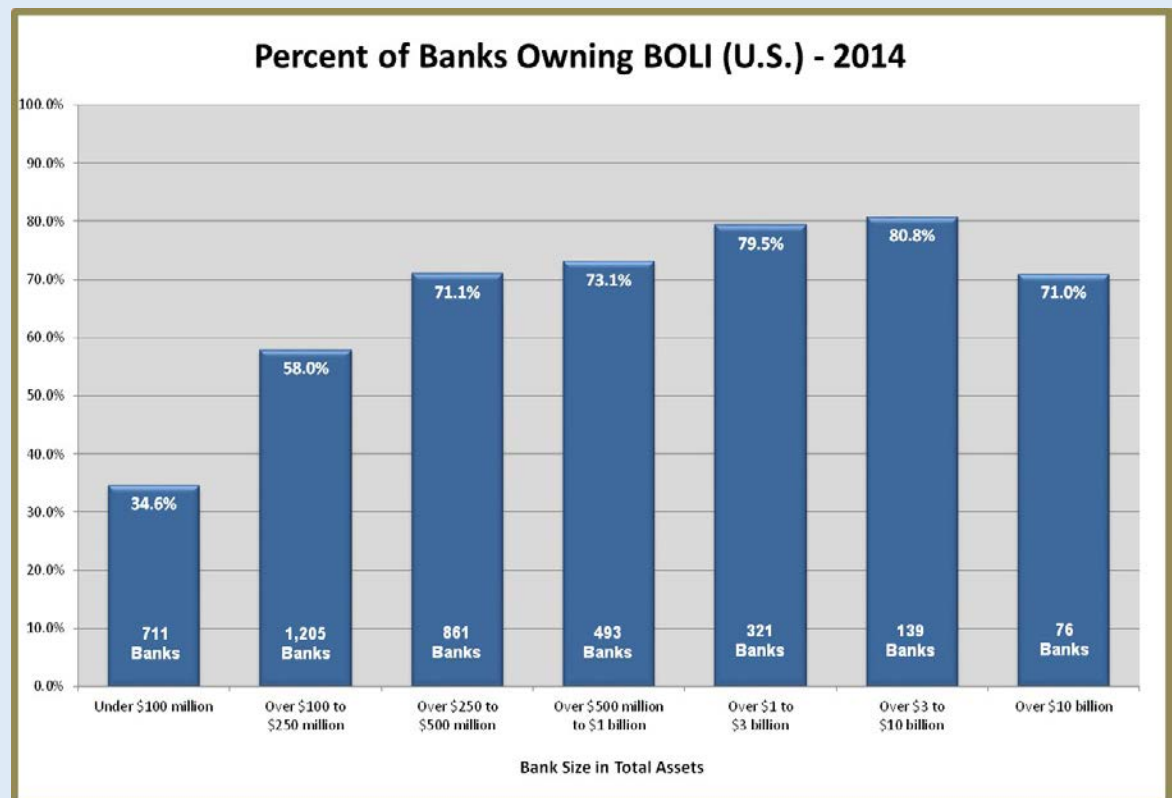
Insurance Company Owned Life Insurance from a Regulatory Perspective

(continued)

Because of the persistent low interest rate environment, all ICOLI sold in the market today is universal life. Universal life products have a minimum guaranteed interest crediting rate and maximum guaranteed charges, and are an "unbundled product." Simply put, it should be thought of as a life insurance product made up of two buckets. One bucket, the "cash bucket," represents the cash value and the other bucket, the "death benefit bucket," the death benefit. As long as there is sufficient cash in the cash bucket (maintained through premium payments and investment earnings) to cover the cost of the death benefit in the death benefit bucket, the policy owner has life insurance protection.

Bank Owned Life Insurance (BOLI)

The financial data for ICOLI's sister product, bank owned life insurance (BOLI), is available from the FDIC Call Reports and is much more comprehensive and current. As of the end of 2014, there was approximately $150 billion of cash value life insurance held by banks in the U.S. Over 56% of the U.S. banks held BOLI. The average amount held was approximately 13% of the bank's Tier 1 Capital, which roughly approximates shareholders' equity less certain deductions. See the following graph for information on U.S. Bank ownership of BOLI.



Insurance Company Owned Life Insurance from a Regulatory Perspective

(continued)

Universal life can be further broken down into three subcategories: general account, separate account, and hybrid. The reference to "general account" simply means the cash in the cash bucket is held and managed in the carrier's general investment portfolio and is subject to the carrier's declared crediting rate.

A separate account product is a universal life product in which the assets are placed in a fund that is separate from the carrier's general account and is separately managed.

The hybrid product has features of both separate account and general account. The life insurance carrier generally supports the cash value and death benefit in the hybrid carrier's separate account.

The salient features of each of these products are summarized in the below chart.

Characteristics	Whole Life	Universal Life		
	General Account	General Account	Separate Account	Hybrid
Guaranteed Cash Value & Death Benefit	Yes	None Risk of Lapse	None Risk of Lapse	None Risk of Lapse
Crediting Rate	Portfolio	New Money or portfolio	Based on Stable Value & Yield to Worst of Sep. Acct.	Book Yield
Mark to Market Risk	None	None	Yes, Depends on Stable Value Floor	None (No Stable Value)
Risk Weighting: Insurance	5% P&C Cos.	5% P&C Cos.	[Possibly 5% P&C Cos.]	[Possibly 5% P&C Cos.]
Investment Choices	None, Carrier General Account	None, Carrier General Account	Several Subject to Stable Value Wrap Provider	Limited
Bankruptcy Risk	Yes	Yes	Separate Account May Be Protected, Matter of State Law, Untested in Courts *Death Benefit at Risk*	Separate Account May Be Protected, Matter of State Law, Untested in Courts *Death Benefit at Risk*
1035 Exchange Restrictions	Yes	Yes	Yes, Market Adjustment, Stable Value Fees	Yes
Cost Disclosures	Generally No, Bundled Product	Generally Yes	Yes	Generally Yes
Mortality Risk	Carrier	Carrier	Carrier or Experience Rating	Carrier, But May Be Limited by Experience Rating
Complexity	Simple	Simple	Generally Requires Legal, Accounting, Actuarial and Investment Advice & Expertise	More Complex

Because of the complexity and unique structure of separate account products, this article necessarily concentrates only on general account universal life ICOLI products.

Insurance Company Owned Life Insurance from a Regulatory Perspective
(continued)

The increase in the cash value of the product is tax-free unless the cash is accessed from the policy through a withdrawal, loan, or policy surrender.

Tax Treatment

Because ICOLI is generally funded with a single premium, the policy is treated as a modified endowment contract (MEC) for Federal income tax purposes. The increase in the cash value of the product is tax-free unless the cash is accessed from the policy through a withdrawal, loan, or policy surrender. If the cash value is accessed through a withdrawal, loan, or by surrendering the policy, the insurance company is taxed on the gain in the policy to the extent of the cash received plus a 10% MEC penalty on that gain. There is an aggregation rule that applies to all policies issued from the same insurer so that the gain on accessing the cash from one policy is determined by looking at the gain in all the policies from the same insurer. Because of the application of these taxes in the event cash is accessed from the policy during the insured's lifetime, the ICOLI policy is generally held until the insured dies. At that point, the death benefit is received income tax-free.

The one exception to the tax-preferred treatment of ICOLI is the application of the alternative minimum tax. The cash value growth in the policy and the death benefit are included in the computation of adjusted current earnings for alternative minimum tax purposes. If an insurance company is in an alternative minimum tax situation, it should evaluate the potential impact an ICOLI policy could have on the company's alternative minimum tax liability.

For purchases of ICOLI after August 17, 2006, favorable income tax treatment of the death benefit proceeds will only apply if the insurance is placed on directors or the highest-paid 35% of the employer's employees. [Internal Revenue Code § 101(j).] Each insured employee and/or director must also be informed of the maximum amount of insurance being placed on them, consent in writing to being insured, and be informed that the employer would continue to be the owner and beneficiary of the insurance even after their termination of employment.

The insurance company purchasing ICOLI must also file IRS Form 8925 for purchases of ICOLI after August 17, 2006, unless the ICOLI policy was received in an IRC Section 1035 exchange of a policy acquired before that date, provided the policy has not been materially modified.

How should insurers value and report ICOLI?

Per SSAP 21, ICOLI is an admitted asset to be carried at cash surrender value. The accounting for ICOLI under statutory accounting principles ("SAP") follows generally accepted accounting principles or "GAAP." The applicable GAAP guidance is contained in ASC Subtopic 325-30 (formerly FASB Technical Bulletin 85-4 and EITF Issue No. 06-5), which requires that life insurance be recorded as an asset at its cash surrender value. Changes in cash surrender value for the period are recognized as income or expense. No income taxes are recorded if the intent of the policy owner is to hold the policy to its maturity (ASC 740, formerly FAS 109), which is generally the case with ICOLI.

Insurance Company Owned Life Insurance from a Regulatory Perspective

(continued)

Nearly all insurance companies that own ICOLI report the ICOLI holdings on Line 25 of Page 2 (Assets) as "aggregate write-ins for other than invested assets." There is no standardized language used to identify write-in details, but clarity should be the goal (e.g., Cash Surrender Value of ICOLI, Insurance Company Owned Life Insurance Cash Value, etc.). We occasionally see ICOLI holdings appear in Schedule BA. The few companies that report in this manner are the outliers. Increase in cash value underlying the ICOLI is recorded by property/casualty insurance companies in Line 14 of Page 4 (Statement of Income) as "aggregate write-ins for miscellaneous income" (the corresponding line item on the statutory filings of life insurance companies is Line 8.3 of Page 4 (Summary of Operations)). Details of those write-ins appear at the bottom of Page 4.

What are the regulatory considerations regarding ICOLI?

As a general rule there are no specific regulations governing the purchase and risk management of ICOLI. For rating purposes, Standard & Poor's recommends that ICOLI not exceed 25% of the insurance company's capital and adjusted surplus. It further recommends that the insurance company limit its ICOLI exposure to any one carrier to 10% of the company's capital and adjusted surplus.

Since ICOLI is not an invested asset, the NAIC does not impose a charge under its RBC (Risk Based Capital) framework. Under A.M. Best's capital formula, Best's Capital Adequacy Ratio (BCAR), general account ICOLI like the product detailed in these materials receives a baseline Asset Risk Factor of five percent (5%) in the case of property/casualty insurance companies and eight tenths of a percent (0.8%) in the case of life insurance companies. A.M. Best analysts may increase or decrease the baseline charge depending on several factors (e.g., carrier credit quality, concentration of ICOLI relative to surplus, etc.).

In addition to the SAP and GAAP guidance, it may also be beneficial to review the guidelines provided by the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") as well as other Federal bank regulators governing the purchase and risk management of life insurance held by banks (BOLI) to the extent those guidelines are otherwise applicable to an insurance company. The Guidelines may be found in OCC Bulletin 2004-56 and FDIC FIL-127-2004, Interagency Statement on the Purchase and Risk Management of Life Insurance, dated December 7, 2004.

Risk Management - Recommended Procedures

The risks most applicable to ICOLI are interest rate risk, credit risk, and liquidity risk. Regulators should understand these risks and review a company's documentation of the mitigation measures it has taken prior to purchase.

We have developed a list of 6 steps to assist regulators in assessing an insurance company's ownership of ICOLI. These recommended procedures

were derived from the "Nine-Step Due Diligence Process" first presented at the Office of the Comptroller of the Currency's National Capital Markets Conference in December 2009 as a methodology banks could use in evaluating a BOLI product. These guidelines have been modified for insurance company regulators.

1. Did the insurance company review the life insurance carrier's ratings from A.M. Best, S&P, Fitch, and Moody's?

The Banking Guidelines state that "carrier selection is one of the most critical decisions in a BOLI purchase [and] credit quality is a key variable." The ratings reflect the carrier's claims paying ability, which is the insurance company's ultimate investment risk. The insurance company should also review the carrier's past financial ratings for trends.

2. Ask management how the insurance company is protected if the carrier withdraws from the ICOLI market

A number of ICOLI carriers have either withdrawn from the market or have suspended ICOLI sales. The question is whether the carrier will continue to support its ICOLI product if it is no longer active in the market. It is best if the carrier has a consistent track record in the ICOLI market. Most ICOLI products today have restrictions and penalties that make it difficult to exchange out of an ICOLI product. The opportunities to change carriers in the future can be severely limited.

3. What are the insurance company's options if the carrier has problems?

One common misconception insurance companies may have about ICOLI is that if the carrier has a problem the insurance company can always exchange out of the product tax-free under Section 1035 of the Internal Revenue Code. This may not always be the case. First, the insurance company must have an insurable interest in the person insured by the policy. If the insured person is no longer employed at the company, then the company no longer has an insurable interest and an exchange may not be made. Secondly, if the policy is medically underwritten and the insured has experienced health problems, an exchange may no longer be possible. Finally, there could be exchange charges and restrictions, which would make it expensive or time consuming to make the exchange.

A second option is simply to surrender the policy. A surrender, however, would trigger income tax on the investment gain in the policy plus a 10% MEC penalty on that gain.

The bottom line is regulators should be aware of the insurer's limited ability to exchange out of a carrier's ICOLI product. Getting it right from the start is, therefore, extremely important.

4. Did the insurance company document its review of the ICOLI illustration for cash values and death benefits at guaranteed charges and crediting rates?

Most ICOLI products have a minimum guaranteed crediting rate. These same products also have a table of guaranteed charges and expenses. It is important that the insurer review the illustration at the guarantees, because it may indicate the policy has the potential of actually losing cash value and lapsing at its guarantees.

5. Did the illustration for cash values and death benefits include information up to age 100?

ICOLI is often sold from a rate sheet showing returns on the ICOLI for the first year or the first five years or so. Carriers know this and the temptation is to make their product more marketable by illustrating "teaser" returns in the early years. This can be accomplished either by providing a higher initial gross crediting rate or by back-end loading the mortality and expense charges.

The sales illustration should indicate what the crediting rates are in the product. If the sales illustration shows a higher initial gross crediting rate than its ultimate gross crediting rate then the carrier is enhancing the product's early return.

It can, however, be more difficult to determine whether the carrier is back-end loading the insurance costs. Short of hiring an actuary, the insurance company may be able to determine whether this is being done by simply comparing the cash value returns in the early years to the returns in the later years. Returns should decline as the insured gets older, but a precipitous decline – especially after the first several years – might indicate costs are back-end loaded.

6. Did the insurance company adequately understand the operating fundamentals of the carrier(s) and the ICOLI crediting methodology?

The insurance company should have included in its due diligence analysis a review of the operating fundamentals of the carrier(s) (e.g., investment returns, lapse ratio, mortality and expenses, etc.), which have a direct impact on the overall performance of an ICOLI product. Additionally, the insurance company should have considered the impact of agent commissions and breakpoints on product yield. Finally, the company should have reviewed illustrations showing what the insurance company's return would be today had the ICOLI been purchased from the same carrier several years earlier. If the current crediting rate is superior to that being credited on the carrier's earlier block of ICOLI, it could be attributable to policy enhancements, or, possibly, to the carrier subsidizing new sales off of its existing policy owners

Insurance Company Owned Life Insurance from a Regulatory Perspective

(continued)

In addition to the above guidelines concerning an insurance company's ownership of a general account ICOLI asset, additional guidelines should be used for separate account ICOLI. Although such products are outside the scope of this article, it bears noting here that their complexity merits additional focus. Such additional guidelines include – but are not limited to – reviewing whether the insurance company adequately reviewed the risks associated with investment losses, depletion of cash value, and lapse. The insurer should have considered the resource dedication and complexities associated with ongoing risk management, as well as monitoring of subaccount investments and terms of stable value wrap agreements (if applicable). Additionally, some jurisdictions require legal, accounting, and actuarial opinions to accompany purchases of separate account products, and regulators should make certain that such procedures have been satisfied.

Conclusion

In conclusion, regulators should understand the benefits and risks to insurers associated with ICOLI. ICOLI can provide an insurance company a superior investment return over an alternative fixed income investment with an attractive risk weighting. However, an insurance company must have controls in place to ensure that credit, liquidity and interest rate risk are reasonably mitigated.

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Segment Review
August 27, 2015

Surplus Lines Profit from Underwriting Discipline and Core Competencies

Product diversification, underwriting discipline and market conditions drive profitable 2014 surplus lines results.

Underwriters of surplus lines continued to report profitable results in 2014 including profits from favorable reserve development. Results were driven by a combination of product diversification, underwriting discipline, and advantageous market conditions. As a result, surplus lines companies continue to outperform the overall property/casualty industry and recorded a second straight year of underwriting profitability following three years of underwriting losses.

A. M. Best's outlook on the surplus lines insurance market remains stable. In addition, the overall macroeconomic environment has been conducive to increased merger and acquisition (M&A) activity. We have seen over the past five years that surplus lines, as well as specialty admitted carriers, have been the target of M&A. Targeted companies provide acquirers an opportunity either to establish a new surplus lines platform, or to supplement an existing one.

Surplus lines insurers also have kept pace with Enterprise Risk Management tools and processes due to increased oversight by regulators and rating agencies. Management at these firms have taken a closer look at their operations from an enterprise standpoint and have either better formalized existing programs or made the necessary adjustments to be more in-line with peers.

The persistent low interest rate environment continues and investment portfolio returns suffer as carriers struggle to replace maturing, and higher yielding, securities with suitable replacements without adding to credit and liquidity risk.

In January 2015, NARAB II was signed into law by President Obama as part of the Terrorism Risk Insurance Program Reauthorization Act of 2015. The market view is that NARAB II will make it easier for agents and brokers to conduct business and make the licensing process more streamlined. Productivity is expected to improve and the cost of business and compliance to decrease.

One of the hallmarks of the surplus lines insurance market is the development of new insurance solutions to address new or emerging risks, or to provide improved coverage for known risks. The core competencies of the successful surplus lines carriers remain the same, focused on effective strategic analysis, product diversification and underwriting discipline. These companies typically concentrate more on bottom-line profits than top-line organic growth, utilizing the segment's freedom of rate and form, while providing coverage for the varied, nonstandard risks that they underwrite. This focus gives these insurers the best chance to withstand adverse market circumstances and succeed over the long term.

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A.M. Best Surplus Lines Market Report - A Retrospective

More than two decades ago, A.M. Best published *Best's Insolvency Study: Property/Casualty Insurers 1969-1990*, in an effort to inform then-active debates over insurers' solvency. Sparked by interest in this topic, the Derek Hughes/NAPSLO Educational Foundation commissioned a similar study in 1994, on the solvency record of the domestic surplus lines industry. The segment was poorly understood by many at the time, but the data showed that, conventional wisdom aside, the surplus lines market's financial stability and solvency were at least on par with the overall property/casualty (P/C) industry.

Over the ensuing years, A.M. Best has published annually a special report on the surplus lines market, commissioned by the Foundation that has documented:

- The market's role in covering new or emerging risks, distressed risks, high-capacity risks, and unique risks that cannot be insured in the standard P/C market.
- The importance of surplus lines insurers' freedom of rate and form, which has allowed for creative insurance solutions to meet specific or unique coverage needs.
- The role of surplus lines distributors, including wholesalers and managing general agents (MGAs), which have played a critical and still growing part in developing products and forging relationships with insureds that facilitate the placement of business in this market.

Throughout its history, the surplus lines market has faced significant obstacles and intense competition. This includes aggressive pricing and liberal coverage from standard market carriers seeking organic growth, and the alternative risk transfer market's appeal as another means of covering potential surplus lines risk. Meanwhile, surplus lines industry representatives have been active in Washington D.C. and individual states on critical regulatory issues affecting the industry, advancing key pieces of legislation. Among these were the National Association of Registered Agents and Brokers (NARAB) provision of the 1999 Gramm-Leach-Bliley Act, which led to nonresident surplus lines agent and broker licenses and a new landscape in wholesale and MGA distribution. More recent actions include passage of the Nonadmitted and Reinsurance Reform Act in 2010, passage of NARAB II, along with the Terrorism Risk Insurance Program Reauthorization Act of 2015 and the introduction of new federal Flood legislation (see section III of this report).

Despite the challenges, the surplus lines market more than doubled from 3.3% of total P/C direct premiums written (DPW) in 1994 to approximately 7.1% by the end of 2014. As a percentage of commercial lines DPW, surplus lines insurers grew from a 6.1% share to 13.9%, hence further demonstrating the undeniable importance of the sector within the overall P/C industry.

Surplus lines companies in 1994 held a higher median A.M. Best financial strength rating (FSR) than the total P/C industry; 85.4% of surplus lines companies had secure ratings (defined as an A.M. Best rating from B+ to A++), compared to 74.2% for the industry. Through mid-year 2015, 100% of surplus lines companies maintained secure ratings versus 95.4% for the P/C industry. Most noteworthy is that 99% of surplus lines insurers have A.M. Best ratings of A- or higher, compared with 78% for the total P/C industry – further corroborating the health of the surplus lines sector today.

The surplus lines market clearly is a safety valve for the insurance industry, especially in hard markets. As emerging issues and exposures drive more demand for creative, comprehensive insurance solutions, A.M. Best believes the surplus lines market will continue to gain in prominence.

Section I – State of the Market

Continuing the momentum established in 2012 and 2013, the surplus lines sector ended the 2014 year in strong form. Leading the parade for this sector was nearly $1 billion of net underwriting profit which included over $525 million of net accident year underwriting profit, plus $376 million of additional profits taken from prior years in the form of favorable reserve development.

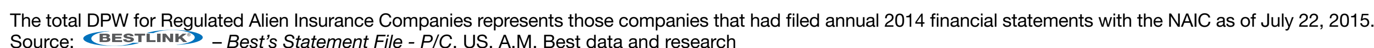
During the year, price momentum continued as direct premiums in this sector grew 6.7% (see **Exhibit 1**) despite competitive pressures domestically and abroad, robust balance sheets in need of putting capital to work, as well as new entrants. There is no doubt that insurers and underwriters have resigned themselves to the reality of today's low interest rate environment and the fact that we are likely to remain in this malaise for some time.

Exhibit 1

U.S. Surplus Lines – Direct Premiums Written (DPW) by Segment (1988-2014)

(USD millions)

	Total P/C Industry		Total Surplus Lines		DOMESTIC PROFESSIONALS				LLOYD'S			REGULATED ALIENS (excluding Lloyd's)				DOMESTIC SPECIALTY			
Year	DPW	Annual % Chg	DPW	Annual % Chg	DPW	Annual % Chg	Surplus Lines Market Share	No. of Cos.	DPW	Annual % Chg	Surplus Lines Market Share	DPW	Annual % Chg	Surplus Lines Market Share	No. of Cos.	DPW	Annual % Chg	Surplus Lines Market Share	No. of Cos.
1988	211,270	4.2%	6,281	-4.3%	3,704	-10.4%	59.0%	86	1,237	-7.5%	19.7%	1,012	31.3%	16.1%	104	328	2.2%	5.2%	128
1989	220,620	4.4%	6,123	-2.5%	3,530	-4.7%	57.7%	88	1,182	-4.4%	19.3%	1,050	3.8%	17.1%	101	361	10.1%	5.9%	123
1990	230,757	4.6%	6,532	6.7%	3,882	10.0%	59.4%	117	1,241	5.0%	19.0%	1,013	-3.5%	15.5%	85	396	9.7%	6.1%	149
1991	235,627	2.1%	6,924	6.0%	4,081	5.1%	58.9%	117	1,322	6.5%	19.1%	1,111	9.7%	16.0%	85	410	3.5%	5.9%	151
1992	240,410	2.0%	7,549	9.0%	4,491	10.0%	59.5%	120	1,388	5.0%	18.4%	1,220	9.8%	16.2%	74	450	9.8%	6.0%	151
1993	253,847	5.6%	8,540	13.1%	5,270	17.3%	61.7%	123	1,631	17.5%	19.1%	1,183	-3.0%	13.9%	70	456	1.3%	5.3%	138
1994	263,653	3.9%	8,786	2.9%	6,089	15.5%	69.3%	115	1,196	-26.7%	13.6%	992	-16.1%	11.3%	64	509	11.6%	5.8%	141
1995	273,929	3.9%	9,245	5.2%	6,511	6.9%	70.4%	112	1,300	8.7%	14.1%	1,022	3.0%	11.1%	57	412	-19.1%	4.5%	144
1996	279,990	2.2%	9,205	-0.4%	6,668	2.4%	72.4%	108	1,354	4.2%	14.7%	818	-20.0%	8.9%	57	365	-11.4%	4.0%	125
1997	287,196	2.6%	9,419	2.3%	6,569	-1.5%	69.7%	106	1,609	18.8%	17.1%	802	-2.0%	8.5%	59	439	20.2%	4.7%	114
1998	300,309	4.6%	9,861	4.7%	6,763	3.0%	68.6%	107	1,574	-2.2%	16.0%	1,196	49.1%	12.1%	58	328	-25.3%	3.3%	113
1999	308,671	2.8%	10,615	7.6%	7,265	7.4%	68.4%	105	1,912	21.5%	18.0%	1,140	-4.7%	10.7%	55	298	-9.1%	2.8%	116
2000	327,286	6.0%	11,656	9.8%	7,884	8.5%	67.6%	98	2,499	30.7%	21.4%	941	-17.5%	8.1%	46	332	11.4%	2.8%	106
2001	367,798	12.4%	15,813	35.7%	10,773	36.6%	68.1%	104	3,368	34.8%	21.3%	1,362	44.7%	8.6%	44	310	-6.6%	2.0%	91
2002	422,703	14.9%	25,565	61.7%	19,572	81.7%	76.6%	108	4,082	21.2%	16.0%	1,600	17.5%	6.3%	46	311	0.3%	1.2%	76
2003	463,033	9.5%	32,799	28.3%	25,662	31.1%	78.2%	115	4,492	10.0%	13.7%	2,400	50.0%	7.3%	45	245	-21.2%	0.7%	63
2004	481,588	4.0%	33,012	0.6%	25,744	0.3%	78.0%	115	4,596	2.3%	13.9%	2,400	0.0%	7.3%	53	272	11.0%	0.8%	59
2005	491,429	2.0%	33,301	0.8%	25,968	0.9%	78.0%	111	4,675	1.7%	14.0%	2,400	0.0%	7.2%	50	238	-12.5%	0.7%	57
2006	503,894	2.5%	38,698	16.3%	29,410	13.3%	76.0%	117	5,989	28.1%	15.5%	3,100	29.2%	8.0%	55	199	-16.4%	0.5%	54
2007	506,180	0.5%	36,637	-3.5%	27,675	-5.9%	74.1%	120	6,360	6.2%	17.0%	3,100	0.0%	8.3%	55	202	1.5%	0.5%	56
2008	492,881	-2.6%	34,365	-6.2%	24,612	-11.1%	71.6%	130	6,062	-4.7%	17.6%	3,403	9.8%	9.9%	53	288	42.6%	0.8%	70
2009	481,410	-2.3%	32,952	-4.1%	22,830	-7.2%	69.3%	139	6,090	0.5%	18.5%	3,735	9.8%	11.3%	55	297	3.1%	0.9%	69
2010	481,120	-0.1%	31,716	-3.8%	21,882	-4.2%	69.0%	143	5,789	-4.9%	18.3%	3,758	0.6%	11.8%	56	287	-3.4%	0.9%	66
2011	501,555	4.2%	31,140	-1.8%	22,582	3.2%	72.5%	146	5,790	0.0%	18.6%	2,537	-32.5%	8.1%	53	231	-19.5%	0.7%	60
2012	523,360	4.3%	34,808	11.8%	25,490	12.9%	73.2%	142	6,270	8.3%	18.0%	2,747	8.3%	7.9%	61	301	30.3%	0.9%	53
2013	545,760	4.3%	37,719	8.4%	26,818	5.2%	71.1%	140	7,099	13.2%	18.8%	3,362	22.4%	8.9%	59	440	46.2%	1.2%	49
2014	570,187	4.5%	40,234	6.7%	28,274	5.4%	70.3%	135	8,157	14.9%	20.3%	3,302	-1.8%	8.2%	60	501	13.9%	1.2%	58



The total DPW for Regulated Alien Insurance Companies represents those companies that had filed annual 2014 financial statements with the NAIC as of July 22, 2015.
Source: BESTLINK – *Best's Statement File - P/C*, US, A.M. Best data and research

In general, the market position of surplus lines insurers continues to be described in favorable terms such as profitable, stable, well-capitalized and consistent performers. These attributes are the result of effective strategic analysis, product diversification, underwriting discipline, advantageous market conditions, and an environment conducive to opportunistic mergers and acquisitions. With a business profile that industry members traditionally refer to as "counter-cyclical", these carriers are extending their trends of favorable overall profitable results. Though some carriers have encountered difficulties, in general the surplus lines carriers remain strong performers and in control of their circumstances.

In our 2015 review of the state of the surplus lines market, A.M. Best will discuss many points, including:

- Market share of the leading members of this line of business
- Factors contributing to financial performance
- Merger and acquisition activity impacting these carriers
- A.M. Best's views on the near-term market cycle.

One advantage to surplus lines insurers is their ability to obtain new business declined by standard carriers at a price deemed supportive of the risk profile. The results for these companies are growth in premium levels, improvement in cash flow, and expansion of the invested asset base. These factors and others led to the surplus lines market recording a second straight year of underwriting profitability following three years of net underwriting losses. It is worth noting that there were no large scale weather events in either 2013 or 2014. A complete review of the aggregate financial results is provided in Section II of this report.

Over the past five years, surplus lines as well as specialty admitted insurers have been the target of mergers and acquisitions (M&A). This is also true of existing insurers who have formed new surplus lines platforms and those that decide to build out their existing platforms. In most cases, M&A activity features strong performing companies targeting other strong performers. This is highlighted by the June 10, 2015 announcement of Tokio Marine & Nichido Fire Insurance Co., Ltd., already active in the U.S. surplus lines market, acquiring HCC Insurance Holdings, Inc. (a key participant in the surplus lines market). HCC, in turn, had recently acquired ProAg Insurance. Additional M&A activity over the past year includes Global Indemnity's purchase of American Reliable and Fosun Group's acquisition of Meadowbrook Insurance. These actions merely mirror similar activity across the insurance industry.

While the latest two years have produced strong profitability, results in earlier years were impacted by weather related losses including Superstorm Sandy in 2012. That event was significant by any measure, and for many surplus lines carriers, it pushed incurred losses to record levels producing results that were outside historical trends and resulted in combined ratios for the Domestic Professional Surplus Lines (DPSL) that exceeded the ratios for the overall property/casualty industry for the first time in more than a decade. In the aftermath, many insurers revisited their books of business in terms of insured exposures and policy terms and conditions.

Enterprise risk management (ERM) programs continue to grow in prominence within organizations, with regulators and rating agencies alike looking to management teams to incorporate or revisit risk appetite and tolerance statements within their ERM structures. In order to adhere to these guidelines, most companies have worked proactively to be compliant while others are trying to keep pace revisiting risk management frameworks, processes and procedures, exposure aggregations, and risk mitigation tactics.

The continuing investment market challenges such as low return rates and headline making defaults (Detroit, Harrisburg, and Puerto Rico) apply negative pressure to portfolios. Carriers with strong balance sheets featuring available capital are under pressure to improve return on equity rates. These conditions are leading standard market carriers to exert greater pricing discipline and minimize risk, while leading surplus lines carriers to exhibit more conservative rate management in concert with obtaining premium levels in-line with loss costs. The end result has been improved performance outcomes across both markets.

The total surplus lines direct written premium is distributed across a variety of corporate structures and company domiciles. **Exhibit 5** consolidates the distribution of premium by segment, representing the increases across the line and by segment. A.M. Best believes this reflects an expanding appetite for appropriately underwritten surplus lines business, including business written through Lloyd's syndicates.

Exhibit 2
Surplus Lines Specialists – Operating Performance (2014)
(%)

Group Name	Change in DPW	Loss/LAE Ratio	Combined Ratio	Pre-Tax ROR (%)	Pre-Tax ROE (%)
Alleghany Insurance Holdings	3.3	54.7	89.1	23.0	14.4
Arch Insurance Group	18.7	64.7	96.1	8.0	6.6
Argo Group	3.8	62.1	97.3	13.3	7.6
AXIS Insurance Group	-0.4	73.4	109.8	-2.2	-1.3
Catlin U.S. Pool	17.6	76.3	97.8	4.1	2.7
Global Indemnity Group	-8.6	62.1	104.1	2.2	1.8
HCC Insurance Group	3.1	47.1	77.5	35.1	14.0
IFG Companies	-11.1	56.4	98.3	11.5	4.6
James River Insurance Company	44.6	56.4	88.7	33.3	10.8
Markel Corporation Group	4.7	57.0	95.8	10.6	8.8
RLI Group	2.2	43.2	84.0	25.3	20.4
W. R. Berkley Group	10.3	59.3	91.7	20.6	19.3
Western World Insurance Group	17.8	23.8	57.8	50.4	35.3
Average - Surplus Lines Specialsts	**8.2**	**56.7**	**91.4**	**18.1**	**11.2**
Total P/C Industry	**4.5**	**69.0**	**97.2**	**12.8**	**9.2**

Source: – A.M. Best Co.'s AMB Credit Report - Insurance Professional

Surplus lines specialists provide wide ranging product diversification to cover the varied exposures that require critical insurance solutions in the market. These specialists, as shown in **Exhibit 2** and **Exhibit 3** generate a significant amount of operating profits, solid returns and favorable reserve development. Surplus lines specialists are U.S. domiciled insurers that primarily write surplus and / or specialty admitted business. These specialists largely exclude companies or groups that are part of a much larger, global multiline insurance operation, but include some specialty groups with Bermuda-based parents.

Reserve adequacy is a material component of A.M. Best's assessment of overall capital adequacy and the ongoing trend of favorable though tightening reserve development for the surplus lines market has been recognized. A.M. Best continues to expect this ability to benefit from favorable reserve development to dissipate. The point at which the industry as a whole is unable to sustain consolidated favorable reserve development may be nearer than before. However, surplus lines carriers that are able to maintain conservative loss reserve selections and support strong balance sheet positions will likely

Exhibit 3
Top Surplus Lines Specialists – Loss Reserve Development (2014 Calendar Year)
(USD thousands)

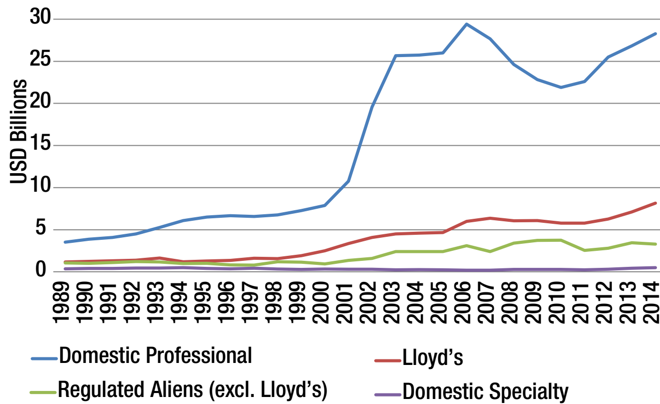
Group Name	One-Year Loss Reserve Development Through 2014 (000)	One-Year Development to Original 2013 Reserves (%)
Alleghany Insurance Holdings	-$218,284	-2.2%
Arch Insurance Group	-$31,754	-2.2%
Argo Group	$2,175	2.0%
AXIS Insurance Group	-$99,596	-5.5%
Catlin U.S. Pool	$13,189	9.9%
Global Indemnity Group	$5,920	2.2%
HCC Insurance Holdings	-$70,546	-4.0%
IFG Companies	-$13,434	-3.5%
James River Insurance Company	-$15,604	-13.3%
Markel Corporation Group	-$164,276	-5.6%
RLI Group	-$66,967	-9.2%
W. R. Berkley Group	-$155,527	-1.8%
Western World Insurance Group	-$178,449	-30.0%
Average - Surplus Lines Specialsts	**-$76,396**	**-4.9%**
Total P/C Industry	**-$6,740,000**	**-1.6%**

Source: A.M. Best data and research

Exhibit 4

U.S. Surplus Lines - DPW by Segment

(1989-2014)

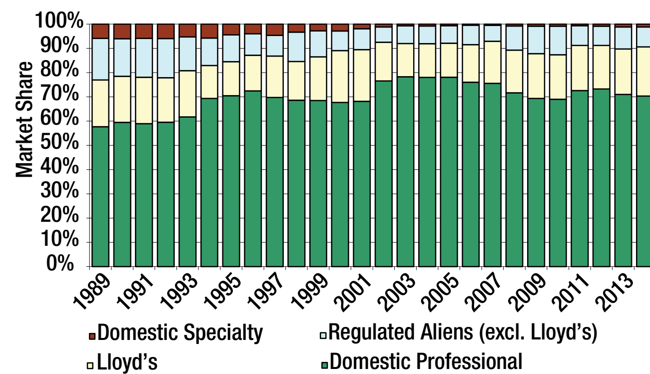


Source: A.M. Best data and research

Exhibit 5

U.S. Surplus Lines – Market Share by Segment

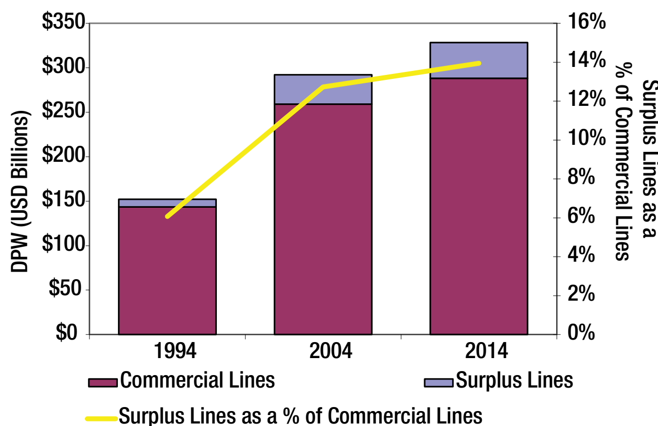
(1989-2014)



Source: A.M. Best data and research

Exhibit 6

U.S. Surplus Lines – Direct Premiums Written vs. Commercial Lines (1994, 2004, 2014)



Source: A.M. Best data and research

have the ability to benefit in forthcoming years and be able to absorb the inevitable fluctuations in loss frequency and severity.

Surplus lines insurers have traditionally applied specialized underwriting to each risk and utilized their freedom of rate and form to serve as a market of last resort. However, A.M. Best has observed an increase of traditional standard market carriers expanding their capacity to write non-standard business with a subsidiary or affiliate structured and designed to operate as a surplus lines company. While none of these companies have enough size to reach the status of a Top 25 surplus lines company (**Exhibit 8**) in terms of direct premiums written many are within striking distance and may reach this level in the coming years as they continue to grow. A handful of these companies are expanding their appetite for nonadmitted business to retain membership within the group or as a diversification play.

For the fourth straight year, domestic professional surplus lines (DPSL) carriers, those writing >50% of their business on a nonadmitted basis, saw their direct premium levels grow. Growth also was seen across other channels when comparing 2014 to 2013 (**Exhibit 4**), notably non-Lloyd's alien companies (this premium is tracked by the National Association of Insurance Commissioners).

Exhibit 6 shows the path surplus lines premium has taken over the last 20 years. Over time, surplus lines premium as a percentage of total commercial lines premium has increased steadily. The proportion seen in 2014 is the highest recorded since first measuring this split.

Further in-depth analysis of surplus lines financial results and measures will be explored in Section II – Financial Condition and Ratings Distribution.

Leading Surplus Lines Companies and Groups

Exhibit 7 encompasses the leading surplus lines organizations, measured on the basis of 2014 direct premiums written. We have already noted that the top position among surplus lines groups in terms of DPW has most recently been held by Lloyd's. The growth in premium written by Lloyd's and the increase in the Lloyd's share of the surplus lines market is a trend that began many years ago. Lloyd's provides a unique platform for partnering with MGAs or for primary insurers looking for reinsurance participants on their surplus lines programs.

Among domestic groups, the largest writer of surplus lines DPW remains AIG, primarily through Lexington Insurance Company. Its direct written premium levels remain near $5.0 billion, a consistent amount over the last five years and reflective of its strengths in the market. AIG has shifted some of its premium production offshore, from Lexington to AIG Europe Limited, a licensed non-Lloyds alien insurance company. This has constrained the total premium captured in the group rankings for the organization, but it is still more than double the surplus lines DPW of the next domestic group. The consolidation of the DPW generated by these two leading groups continues to remain near 30% of the measured surplus lines market.

Most of the composition of the top ten groups remains the same as last year, notably Nationwide Group (through the Scottsdale Insurance Company subsidiary), W.R. Berkley, Zurich Financial, and Markel. These organizations have consistently been among the leaders in surplus lines with long standing relationships and recognizable brand names. There is some shifting among the top groups for 2014 with Ironshore Insurance Group and Berkshire Hathaway accumulating significant gains in premium to reach a top ten position in the market. While Berkshire is making an aggressive run in this space, Ironshore was one of the companies that expected to be acquired by Fosun in 2015.

Exhibit 7

U.S. Surplus Lines – Top 25 Groups (2014)

Ranked by direct premiums written.

(USD Thousands)

Rank	AMB No.	Group Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	85202	Lloyd's	8,157,000	20.3
2	18540	American International Group	4,679,470	11.6
3	05987	Nationwide Group	1,780,987	4.4
4	18252	W.R. Berkley Group	1,485,813	3.7
5	18549	Zurich Financial Svcs NA Group	1,204,753	3.0
6	18468	Markel Corporation Group	1,191,418	3.0
7	18498	ACE INA Group	1,032,388	2.6
8	18728	Ironshore Insurance Group	894,986	2.2
9	00811	Berkshire Hathaway	835,316	2.1
10	03116	Fairfax Financial (USA) Group	793,974	2.0
11	18640	Alleghany Insurance Holdings	780,702	1.9
12	18313	CNA Insurance Companies	745,886	1.9
13	18130	XL America Group	726,916	1.8
14	18603	AXIS Insurance Group	591,135	1.5
15	00012	Chubb Group of Insurance Companies	574,425	1.4
16	18484	Arch Insurance Group	548,931	1.4
17	04019	Argo Group	526,338	1.3
18	18713	QBE Americas Group	522,550	1.3
19	18591	Allied World Group	517,559	1.3
20	04835	Great American P&C Group	472,564	1.2
21	18720	Catlin U.S. Pool	443,724	1.1
22	18604	State National Group	434,505	1.1
23	18783	Aspen US Insurance Group	425,002	1.1
24	18756	Starr International Group	396,987	1.0
25	03262	Swiss Reinsurance Group	378,134	0.9
		Subtotal of Top 25	**$30,141,363**	**74.9**
		Total U.S. Surplus Lines Market	**$40,233,826**	**100.0**

Source: A.M. Best data and research

Exhibit 8

U.S. Surplus Lines – Top 25 Companies (2014)

Ranked by direct premiums written.
(USD Thousands)

Rank	AMB No.	Company Name	Group Name	Surplus Lines DPW	Total Surplus Lines Share (%)
1	02350	Lexington Insurance Company	American International Group	3,780,213	9.4%
2	03292	Scottsdale Insurance Company	Nationwide Group	1,559,064	3.9%
3	03557	Steadfast Insurance Company	Zurich Financial Svcs NA Group	1,051,685	2.6%
4	03535	AIG Specialty Insurance Co	American International Group	899,194	2.2%
5	13866	Ironshore Specialty Ins Co	Ironshore Insurance Group	880,700	2.2%
6	03538	Columbia Casualty Company	CNA Insurance Companies	745,886	1.9%
7	11340	Indian Harbor Insurance Co	XL America Group	726,883	1.8%
8	12515	AXIS Surplus Insurance Company	AXIS Insurance Group	591,135	1.5%
9	04433	Westchester Surplus Lines Ins	ACE INA Group	575,138	1.4%
10	12523	Arch Specialty Insurance Co	Arch Insurance Group	548,931	1.4%
11	02428	National Fire and Marine	Berkshire Hathaway Group	540,747	1.3%
12	12619	Landmark American Ins Co	Alleghany Insurance Holdings	532,764	1.3%
13	02713	Chubb Custom Insurance Co	Chubb Group of Insurance Cos	526,899	1.3%
14	12562	QBE Specialty Insurance Co	QBE Americas Group	522,550	1.3%
15	03283	Colony Insurance Company	Argo Group	522,240	1.3%
16	01990	Nautilus Insurance Company	W. R. Berkley Insurance Group	506,983	1.3%
17	03759	Evanston Insurance Company	Markel Corporation Group	484,732	1.2%
18	02732	Essex Insurance Company	Markel Corporation Group	472,335	1.2%
19	12118	Gemini Insurance Company	W. R. Berkley Insurance Group	467,658	1.2%
20	03510	Illinois Union Insurance Co	ACE INA Group	457,250	1.1%
21	10092	Catlin Specialty Insurance Co	Catlin U.S. Pool	443,724	1.1%
22	03026	Admiral Insurance Company	W. R. Berkley Insurance Group	443,067	1.1%
23	13105	United Specialty Insurance	State National Group	434,505	1.1%
24	12630	Aspen Specialty Insurance Co	Aspen US Insurance Group	425,002	1.1%
25	13977	Starr Surplus Lines Company	Starr International Group	396,987	1.0%
		Subtotal		**$18,536,272**	**46.1%**
		Total U.S. Surplus Lines Market		**$40,233,826**	**100.0%**

Source: A.M. Best data and research

Greater variability is seen further down the top 25 list with a few organizations moving five or more spots up or down. Most member companies experience growth or contraction in direct premium levels as they move into or out of selected lines of business. As always, the counter cyclical nature of the surplus lines market relative to the standard insurance industry leads to a resolute expanding/contracting rhythm for their direct premium. This may launch a group into the top 25, only to see it drop off in later years. A continued trend is the expanded diversity of the market as the population of the top 25 companies shifts. (See **Exhibit 8**.) One ongoing driver is interest from investors for creating new entrants in this market as an investment opportunity is perceived. Another ongoing trend is the advancement of total direct premium, as many of the top 25 group members experienced overall growth in direct premium during 2014. This is a condition of the surroundings as the top surplus lines markets effectively exerted their market influence.

Given the historical trends, it would be a real challenge for any observer to predict how the list of leading companies would look in the near-term future. Although a fair portion of the rankings remain the same from ten years prior (see **Exhibit 9**), constant merger and acquisition activity, start-up companies, and poor operating performance can be expected to add companies to, or subtract them from, the surplus lines market. Even with this dynamic, A.M. Best believes that the top-tier surplus lines insurers, those with a proven track record of favorable operating results, strong balance sheet positions, and supportive market profiles, will retain their position through a combination of disciplined underwriting and product innovation.

Current Challenges

The ability to generate favorable underwriting results is the mainstay of profitability of any insurance company. A.M. Best actively monitors all conditions that impact markets, and as we will note here, certain factors created specific challenges for the surplus lines market participants. Even despite the last two years of strong underwriting profitability, surplus lines companies have been facing tighter operating conditions in order to be able to generate income. These companies continued to serve as a “market of last resort” for the higher hazard classes not served by traditional markets, and that is not expected to change any time soon.

Exhibit 9

U.S. Surplus Lines – Top 25 Groups (2005)

Ranked by direct premiums written.

(USD Thousands)

Rank	Company Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	American Inernational Group	6,977,070	21.0%
2	Lloyd's	4,675,000	14.0%
3	Zurich/Farmers	1,739,701	5.2%
4	ACE INA Group	1,497,092	4.5%
5	Nationwide Group	1,405,160	4.2%
6	W. R. Berkley Group	1,327,155	4.0%
7	Markel Corporation	1,276,579	3.8%
8	Berkshire Hathaway	886,294	2.7%
9	CNA Insurance Companies	814,094	2.4%
10	Arch Capital Group	796,143	2.4%
11	AXIS Insurance Group	630,238	1.9%
12	St. Paul Traveles Companies	599,185	1.8%
13	Argonaut Insurance Group	520,141	1.6%
14	Chubb Group	459,080	1.4%
15	United America Indemnity Group	437,025	1.3%
16	XL America Group	422,740	1.3%
17	RLI Group	390,213	1.2%
18	Great American P&C	367,955	1.1%
19	IFG Companies	361,291	1.1%
20	Hartford Insurance Group	355,823	1.1%
21	HCC Insurance Holdings Group	349,238	1.0%
22	Fairfax Financial (USA) Group	325,082	1.0%
23	HDI U.S. Group	306,218	0.9%
24	Western World Insurance Group	275,104	0.8%
25	Allianz of America	256,797	0.8%
	Subtotal	**27,450,418**	**82.5%**
	Total U.S. Surplus Lines Market	**33,280,702**	**100.0**

Source: A.M. Best Co. Report *Annual Review of the Excess & Surplus Lines Industry*, September 2006

As more companies enter the arena, either as start-ups, reinsurers dropping down to working layers, or standard carriers expanding their appetite and tolerance, competition will likely increase on price, distribution, risk management, and client services. Even with the surplus lines market’s freedom of rate and form, a portion of the market’s capacity is restricted by price sensitivity and unable to advance price corrections without a loss of market share, or for various reasons, still have operations conducted on an admitted basis. The discussion of the investment environment and the adverse impact it is having on the insurance industry has become repetitive. Almost every company across the industry has been forced to evaluate their portfolios and make tough choices to allocations, strategies, and risk / return tolerances. The surplus lines carriers are in this same boat and making the same choices. One area on which A.M. Best has already commented in separate special reports and webinars is diversification within investment portfolios focused on Schedule BA assets, hedge funds, private placements, and 144A holdings. Best has observed an increase in these assets in investment portfolios of surplus lines carriers to a level similar with the overall industry.

Concerns of where to invest “new money” and expectations of depressed future treasury yields are factors cited by insurance executives when discussing investment allocation decisions away from traditional assets. The analysis of investment risk will always have a comprehensive review of portfolio risk. Nonetheless, A.M. Best is alert to the modifications in investment risk tolerances and will take a deeper dive when necessary. Furthermore, in Best’s Capital Adequacy Ratio (BCAR) analyses, more emphasis will be placed on understanding the risk parameters of these vehicles and significantly higher capital risk factors may be applied on the amounts allocated to these investments.

The surplus lines market typically receives credit for being ahead of the curve on innovation. As noted in prior special reports on this market, exposures such as technological advancements, environmental liability, and cyber risks are areas where surplus lines carriers have been able to meet the needs and demands of the markets. Underwriting discipline and sophisticated pricing models allow carriers to design and develop products providing appropriate coverage. The ability to advance these differentiating products continues to benefit this niche as the next generation of new exposures develops.

The greatest challenge to an individual surplus lines carrier may be retaining its market share. Since a fair portion of this business comes from brokers, surplus lines business is generally shopped each year to some extent, resulting in lower policyholder retention. As a group, surplus lines carriers have focused on improving retention via technology, better broker relationships and enhancing their underwriting analytical capability. This leads to a consistently competitive environment for retention. As one carrier tightens its risk appetite and deems certain types of exposures to be outside of its preferred risk profile, another may reach the conclusion it has the expertise and capability for that same risk.

In an effort to retain market share, some surplus lines organizations have enhanced their network through acquiring renewal rights or establishing new MGAs. Another area of concern for traditional surplus lines carriers is the fact that new entrants and new parents of existing players are likely to create even more competition. Additionally, reinsurers have made moves to "drop-down" into primary layers. Also, new start-up companies, often financed by private equity looking for investment opportunities, can threaten the market share of established surplus lines insurers. The diversification and expanded capacity in the market is expected to continue to drive investment by current incumbent market leaders in their own systems, capabilities, and core competencies in order to retain their positions in this market.

The Lloyd's Market

Lloyd's has been active in the United States since the late 1800s. As the top writer of nonadmitted business from 2010 through 2014, it plays an extremely important role in the surplus lines market. The United States continues to be Lloyd's biggest market, with surplus lines and reinsurance activities generating the majority of Lloyd's U.S. sourced revenues. Risks underwritten by Lloyd's vary considerably, encompassing both property and liability loss exposures. With roughly $8.2 billion in DPW in 2014, Lloyd's represents approximately 20.3% of the surplus lines market.

Over the past decade, Lloyd's surplus lines premium volume has grown from increased marketing activity, new agency appointments, risk-bearing affiliates of syndicates, and the enhanced awareness of Lloyd's security ratings among buyers and producers. Lloyd's surplus lines premium continues to exceed the combined premium levels of its U.S. reinsurance and direct business. Overall, A.M. Best believes Lloyd's will continue to maintain its substantial participation in the U.S. surplus lines market, despite the volatile earnings inherent in surplus lines business.

Mergers & Acquisitions

The insurance industry appetite for mergers and acquisitions continues to make news headlines. Surplus lines carriers may not be the primary source of this news, but they are making waves. One such extremely noteworthy item is the continuing narrative of AXIS Capital Holdings Ltd., the ultimate parent of AXIS Surplus Insurance Company, which as of 2014, was the 14th largest surplus lines carrier. A transaction that would combine AXIS Capital with PartnerRe Ltd. was initially announced January 25, 2015. Subsequent involvement in the bidding for PartnerRe by Exor S.p.A. led to ongoing negotiations, court activity, and a delay in the initial merger proceedings moving forward. On August 3, it was announced that Exor had won the bid to acquire PartnerRe for $6.9 billion of $140.50 per share. A.M. Best will continue to monitor developments relative to this announced purchase.

Likewise, on July 1, 2015, it was announced that Ace Ltd. will acquire Chubb Corporation in a transaction valued $28.3 billion. Both of these organizations derive significant levels of their direct premium from the surplus lines market.

Activity that has already reached completion in 2015 included XL Group plc closing its deal to take ownership of Catlin Group Limited. This acquisition was announced January 1, 2015, and subsequently closed May 1, 2015. This consolidation of two members of the top 25 U.S. surplus lines groups has had an impact on the market, including narrowing the field and dispersing talent.

HCC Insurance Holdings, Inc. (HCC) announced in October 2014 and closed on January 1, 2015 their acquisition of Producers Ag Insurance Group from CUNA Mutual Group. Though crop insurance is not written on a surplus lines basis, many large insurers and reinsurers have been interested in crop insurance due to its product specialization, technology and the benefits afforded through government support and subsidies. The Producers Ag acquisition further strengthened HCC's product and earnings diversification. In a transaction announced June 10, 2015, Tokio Marine Holdings, Inc., through its subsidiary Tokio Marine & Nichido Fire Insurance Co., Ltd., is acquiring HCC for a total of $7.5 billion. Tokio Marine's purchase of a U.S. based property casualty insurer marks its second big splash since acquiring Philadelphia Consolidated Holding Corp for $4.7 billion in late 2008.

Another transaction first announced late in 2014, after the publication of the 2014 surplus lines report, involved Meadowbrook Insurance Group (Meadowbrook). In July 2015, Meadowbrook was acquired by Shanghai based investment group, Fosun International Ltd. In a separate deal announced in May 2015, Fosun announced its plans to acquire the remaining interest in

Stamping Offices Report Growth in Surplus Lines Premium

According to information compiled by the Surplus Lines Stamping Office of Texas, the 14 states maintaining stamping offices reported a 7.6% increase in premium volume during 2014, compared with a 16.0% increase in premium volume in 2013. However, part of the large increase in 2013 reflected a constriction of growth in 2012 due to a large amount of prior years' return premium transactions processed in New York.

Likewise, the stamping offices reported a 6.9% increase in the number of documents filed: 3.4 million in 2014, compared with 3.2 million in 2013. The document count indicates the number of policies and endorsements handled by the various stamping offices. A change in document count provides a rough estimate of the flow of business into and out of the surplus lines market.

The stamping offices only report on 14 states, and the results are influenced heavily by four states — California, Florida, New York and Texas. California generated the highest premium volume of these states, consistent with its ranking in 2013. California recorded the second highest increase in premium during 2014 versus 2013. Only Utah recorded a higher increase at 18.8%. By document count, the leading states continue to be Florida and Texas.

Through the first six months of 2015, the reported document count reveals an increase of 5.3%, compared with an increase of 9.5% in the same period of 2014. Premium growth during the first six months of 2015 was 9.5%, up from the 4.8% increase in 2014. California showed the strongest growth and highest premium volume.

The increase in premium by state exceeding the increase in the number of items processed reflects the underwriting discipline and adherence to adequate pricing in the surplus lines market, which A.M. Best believes will continue at least through the end of 2015.

Ironshore Inc., for $1.84 billion. These transactions further enhance Fosun's plans to build out its insurance business globally.

In a relatively minor transaction, Assurant Inc., one of the smaller surplus lines market participants, streamlined its organization with the sale of American Reliable Insurance Company to Global Indemnity. This transaction will allow Global Indemnity to expand into complementary surplus lines of business and achieve certain economies of scale.

Shortly after the publication of this special report last year, the acquisition of Western World by Validus was completed. This acquisition represented another clear example of a recognized reinsurer making a bold move into the U.S. surplus lines arena.

The next transaction cannot be predicted; however, it is almost a certainty that there will be additional mergers or acquisitions within the surplus lines market in the near term. Capital needs to be allocated where it will create favorable returns for appropriate risks. Across the industry, the option for entering or strengthening a position within a business line is moving into a more prominent position in the market, especially for those with a strong balance sheet position. Add to this the challenge of depressed returns on investments and the result is a continuing appetite for merger and acquisition activity.

A.M. Best's View of the Surplus Lines Market

The state of the surplus lines market through the remainder of 2015 is viewed to be stable. This view takes into consideration continued modest economic improvement, GDP growth of approximately 3%, moderate loss cost inflation between 2 to 4% and an incremental rise in interest rates in the range of 250 to 350 basis points by year end 2015. Equally important, this view assumes some degree of price discipline on the part of surplus lines insurers and to some extent, similar behavior from standard market insurers. A.M. Best believes that today's prevailing low interest rate environment will help to keep aggressive pricing on the sideline. This perspective also anticipates a continuation of favorable prior year reserve releases albeit at a lesser pace.

Using an average return on investment of 5%, A.M. Best believes that surplus lines insurers in the aggregate should be able to sustain a rate of return on equity at or greater than 10% in 2015. This assumes a combined ratio of 90% to 95%, attritional loss ratio between 60% to 65% and non-attritional losses of 5% including storm activity. This also assumes the continued benefit of favorable prior year reserve development.

A.M. Best views the surplus lines market as stable from a ratings perspective and expects that the vast majority of surplus lines insurers will have their ratings affirmed. While this is our general view of the market, many conditions, such as underwriting profitability, competition, new products, investment returns, and reserve development, will affect our analysis of each company operating in this line.

Over the last ten years, the surplus lines sector recorded seven years of underwriting profit, with the exception being three consecutive years from 2010 through 2012. A.M. Best expects 2015 to be another fruitful year of underwriting profitability for this niche.

We have observed that despite all of the challenges, carriers in general are maintaining pricing discipline. Our perspective for an upbeat 2015 also contemplates three points of catastrophe losses in the year – a point impact similar to the assumption used in our forecast for commercial lines insurers. It should be noted that surplus lines carriers, by nature of the specialized business and risk appetite, will remain exposed to large losses such as natural catastrophes and terrorism events. Weather-wise, the hazard comes from a variety of events

(hurricanes, tornadoes, polar vortex), but the prudent carriers remain forefront as they monitor the risks. Terrorism exposures also continue to be a primary concern. Advances in risk assessment, use of standard reinsurance, and passage of TRIPRA 2015 (discussed in detail later in this report) partially mitigate this concern. Regardless of the extent that the impact of these events on a book of business can be minimized, their occurrence patterns may be less predictable than ever. That noted, models, TVAR calculations, and PML accumulation monitoring are necessities for day-to-day decisions.

Another key element in surplus lines carrier operations is the extensive commitment to develop and implement more sophisticated technology. These measures already are proving valuable in interfacing with producers in an efficient manner, parsing volumes of data to identify desirable risks versus problematic ones, tracking underwriter and producer success, and actively monitoring risk accumulations on a highly defined level. It is getting to the point that if an insurer is not taking effective advantage of these capabilities, it likely will be fighting an uphill battle for relevance and viability in the surplus lines markets.

Successful surplus lines carriers are those whose boards and management teams have been able to apply strategic options to turn threats into opportunities. Application of underwriting capability to reverse poor experience in a highly specialized line is just one example of turning the tables on perceived weaknesses in a business profile. One way to assess this is implementation of a risk appetite and tolerance statement. A.M. Best began requesting these from all insurance carriers through the 2014 Supplemental Rating Questionnaire distributed during the first quarter of 2015. Organizations that have the ability to clearly and succinctly state and implement these measures will be in a better position to retain or enhance their positions in the surplus lines market. Even with all of these items, the expectation of surplus lines carriers and their long term success remains grounded in key factors: freedom of rate and form, ability to maintain price integrity, a focus on bottom line stability, balanced risk / reward tolerance levels, strong investment returns, and enterprise risk management capability exceeding risk profiles.

Conclusion

Through the first half of 2015, overall market conditions remain comparable with 2014, demonstrating ongoing competition, low interest rates and limited weather related events. With persistently low interest rates providing only marginal investment returns, underwriting performance remains as the leading driver of operating performance. Total investment income from both traditional and higher yielding asset classes are needed to provide additional support to income and surplus.

The core competencies of the successful surplus lines carriers remain the same, focused on effective strategic analysis, product diversification and underwriting discipline. Advantageous market conditions and an environment conducive to opportunistic mergers and acquisitions only further benefit the strong carriers. Competition continues to expand in this market either through affiliated companies, new entrants or M&A activity. Even with the best ability to focus on their own performance, surplus lines carriers remain exposed to external factors, such as economic conditions and judicial or regulatory concerns that can and will interfere with daily operations and financial success.

Historically, the best surplus lines insurers have focused on maintaining the underwriting and pricing integrity that have been the hallmark of this market segment. These companies typically focus more on bottom-line profits than top-line organic growth, utilizing the segment's freedom of rate and form, while providing coverage for the varied, nonstandard risks that they underwrite. This focus gives these insurers the best chance to withstand adverse market circumstances and succeed over the long term. A.M. Best expects surplus lines insurers to concentrate on using proven fundamentals to overcome the execution risk presented by current and future underwriting and investment market conditions.

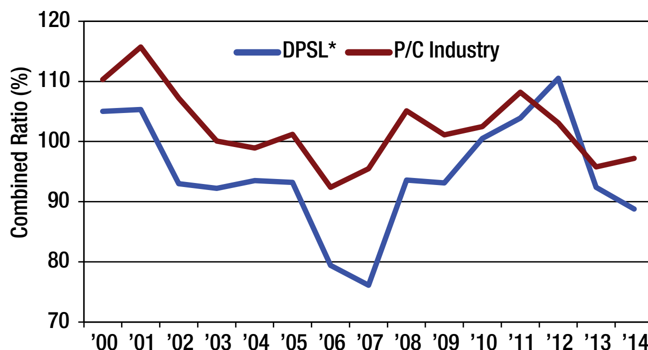
Section II – Financial Condition and Rating Distribution

In the past, A.M. Best was able to report with near certainty the surplus lines premium volume written by the 73 companies that make up the Domestic Professional Surplus Lines (DPSL) composite. (See sidebar, *A.M. Best's DPSL Peer Composite Defined*.) However, as the industry advances, multiple admitted and non-admitted specialty carriers have been established within the same group. With these, risk-sharing tools such as pooling agreements and internal reinsurance programs have been employed, blurring the statutory reporting lines between the segments and their related data.

For example, on January 1, 2014, Lexington Insurance Company expanded their pooling agreement with more entities from across numerous AIG segments, mixing standard and surplus lines business into a homogenous pool shared among the participants. Though this strategy is not unprecedented, the magnitude of the agreement has led to an extraordinarily substantial impact on the surplus lines premium data for 2014. In particular, during 2013, Lexington Insurance Company assumed $1.6 billion in premium. With its new pooling agreement, the amount of the company's assumed premium increased almost 550%, to $10.2 billion. As Lexington is a component of the DPSL composite, those results also were impacted with an increase in assumed premium from $4.9 billion in 2013 to $12.6 billion in 2014. Though partially offset by the sharp increase in ceded premiums ($11.2 billion in 2014 from $8.5 billion in 2013), the effect on the composite's net written premium was still substantial, increasing 20% to $10.6 billion from $8.8 billion in 2013.

Exhibit 10

U.S. DPSL* – Combined Ratios vs. U.S. P/C Industry



* Domestic Professional Surplus Lines
Source: A.M. Best data and research

A.M. Best's DPSL Peer Composite Defined

The analysis in this section is based on the statutory financial data of the 73 U.S.-based domestic professional surplus lines (DPSL) companies. The DPSL composite produced approximately $15.9 billion in direct premiums written (DPW) in calendar year 2014, representing approximately 39.5% of the total U.S. DPSL market as defined in this report.

DPSL companies are identified as those that write at least half of their business on a nonadmitted basis. These organizations historically have accounted for approximately two-thirds to three-quarters of the total surplus lines market.

To determine the population of true DPSL companies for the purpose of this section and the comparisons herein, A.M. Best excludes surplus lines companies that are members of intercompany pools that predominantly write admitted business as opposed to surplus lines business; those companies that reinsure all of their business with an affiliate, and companies that write a relatively small amount of premium. The DPSL composite, however, does include companies that may be part of an intercompany pool, but still write surplus lines business predominantly on a direct basis and retain a substantial portion of this business.

As the lines between classes of business become less clear, operational and strategic changes made by the larger players in the industry will inevitably alter the juxtaposition of data between periods.

DPSL Peer Composite Overview

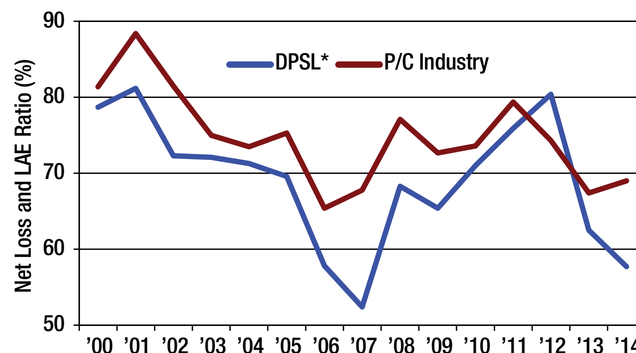
A.M. Best's domestic professional surplus lines (DPSL) composite is a consolidation of 73 U.S.-based DPSL companies committed to the surplus lines space and provides a good indication as to the health of the surplus lines sector. In 2013 and 2014, direct written premium for this composite grew at 3.5% and 3.3%, respectively. As for net written premiums, growth in 2014 was 19.9%

Similar to the segment's performance in 2013, the DPSL composite continued to outpace the operating and underwriting results posted by the P/C industry in 2014. Benefiting from another benign catastrophe year in 2014, the composite posted loss ratios below the prior year in most lines of business, which helped achieve the lowest overall loss and LAE ratio since 2007. (See **Exhibit 11**.) Also helping to sustain underwriting profits in 2014, was the steady increase in direct premium writings, supported by exposure and rate growth.

Notwithstanding the companies' consistently profitable performance, the composite still struggled in 2014, with low investment yields and continued excess capacity. The sharp decline in investment yields was the result of an increased asset base but with a decrease in investment income, driven by the low interest rate environment. This occurred despite an increase in common stock allocations that provided an opportunity for diversification.

Exhibit 11

U.S. DPSL* - Net Loss & Loss Adjustment Expense Ratios vs. U.S. P/C Industry



* Domestic Professional Surplus Lines
Source: A.M. Best data and research

Operating Performance

The DPSL composite continues to clearly outpace the underwriting and operating results of the total P/C industry, as evident in the composite's 99.0 and 99.3 five- and ten-year combined ratios, compared with 101.2 and 101.1, respectively, for the total P/C industry. (See **Exhibit 10**.) It's important to note, also, that the composite's combined ratios in 2013 and 2014, at 92.4 and 88.8, respectively, were well below their five- and ten-year averages and the total P/C industry's combined ratio in those years. Furthermore, the DPSL composite posted lower combined ratios than the total P/C industry in nine out of the last ten years, though the difference between the two has narrowed.

The impact on surplus lines insurers' underwriting profitability from prior years' weather-related losses has lessened, since the segment's innate exposure to catastrophe-prone risks hasn't been taxed since the storms of 2012. The lack of significant weather-related events in 2014 boosted the underwriting performance by tempering the composite's pure loss ratio to 44.7, its lowest level in over five years. This compares very favorably to the total P/C industry's 2014 loss ratio of 57.2. The underwriting controls and pricing discipline exhibited throughout the surplus lines market ensures the continuity of secure capitalization levels moving forward.

The DPSL composite's operating ratio still compared favorably to that of the total P/C industry in 2014, at 72.3% compared to 86.1%, though the gap between the two narrowed from 2013

(13.8 pts. vs. 19.8 pts.). This reduced spread is attributed to the composite's diminished net investment ratio of 16.5% compared to 26.8% in 2013, with both an increased premium base and a 26% decline in investment income driving this trend. Nonetheless, 2014 marked the composite's second best operating performance since 2007 (2013 was the best), which is a testament to the strength and consistency of the surplus lines segment.

Posting the second-straight year of underwriting profitability, the composite was well-positioned to offset the decline in investment income with underwriting performance. Pretax operating profits in 2014 rank well historically, as higher operating profits were only seen in four of the last ten years, one of which was 2013. The step back from 2013 levels was caused by the decline in investment income. Mirroring the operating profitability, the composite's net income remained strong at $2.8 billion, a moderate 17% decline from 2013's near-record level.

Though net income through the composite was strong in 2014, essentially none was passed through to policyholder surplus, as surplus levels dropped 1.7%. The stockholder dividends paid out more than offset the favorable net profitability, which indicates strong capitalization and optimism throughout the segment. This dip in surplus levels contrasts with the total P/C industry's 3.4% increase.

Despite this disparity in surplus growth, the DPSL composite's pretax returns outperformed the total P/C industry by a strong margin. (See **Exhibit 14**.) Reflecting the prior ten years, the 2014 DPSL composite exceeded the total P/C industry's total return on revenue at 32.3% and 14.0%, respectively, and total return on equity at 14.8% and 10.1%, respectively. This favorable trend has persisted throughout even the high catastrophe event years, evident of the surplus lines segments emphasis on strong underwriting controls, superior capital position, risk selection and diversification, as well as operating efficiency.

Net Investment Gains

The DPSL's net investment income again reversed course in 2014, falling 26.1% after increasing by 11.0% in 2013. (See **Exhibit 12**.) However, the overall P/C Industry recognized the opposite result, increasing 11.5% in 2014 and falling 1.1% in the previous year. For the fourth straight year, the DPSL composite increased its total stock allocation, now approaching $10.9 billion, whereas the bond allocation has declined since 2011, and now stands at $31.1 billion. The increase in stock allocation is also supported by a diminishing cash and short-term investment allocation, now a mere 5.7% of total admitted assets throughout the composite. Generally, the trend of increasing stock allocation is also evident in the total P/C industry, although to a slightly lesser degree. Of course, this increase in "stock allocation" was driven, in part, by the appreciation in the market value of these assets over the last few years.

Exhibit 12

U.S. DPSL* Composite – Investment Performance vs. P/C Industry

(USD Billions)

	DPSL * 2013	DPSL* 2014	Year/Year Change (%)	Total P/C Industry 2013	Total P/C Industry 2014	Year/Year Change (%)
Net Investment Income	2,357	1,741	-26.1	49,501	55,179	11.5
Realized Capital Gains or (Losses)	554	843	52.2	12,141	12,086	-0.5
Net Investment Gain	2,911	2,584	-11.2	61,642	67,265	9.1
Unrealized Capital Gains or (Losses)	865	563	-34.9	38,611	4,215	-89.1
Total Investment Return	3,776	3,147	-16.7	100,253	71,480	-28.7

*Domestic Professional Surplus Lines
Source: A.M. Best data and research

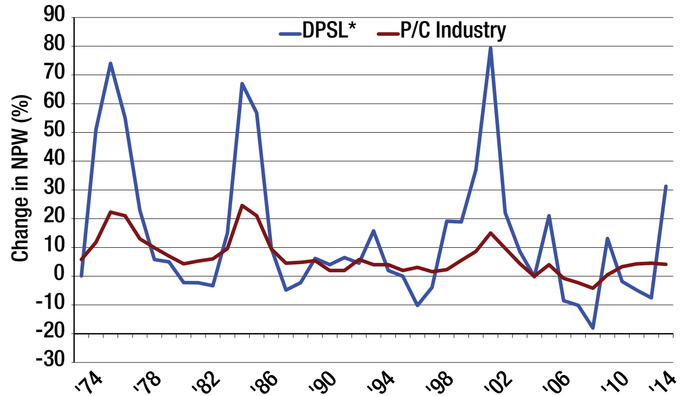
In 2014, the composite's realized gains of $843 million and unrealized gains of nearly $563 million on investments softened the decline in total investment return to 8.5% when compared to 2013. The P/C industry experienced a more pronounced (approximately 29%) decline in its total investment return, which was driven by below-average unrealized capital gains.

Favorable Loss-Reserve Development

Throughout the past few years, favorable prior-year loss-reserve development has boosted the overall P/C industry's underwriting profitability. Likewise, favorable reserve development reduced the DPSL composite's loss ratio by 3.6 points in 2014, though less than the 8.5 points in 2013. Mirroring the DPSL composite, the overall P/C industry recognized a 1.9 and 3.6 point reduction in 2014 and 2013, respectively.

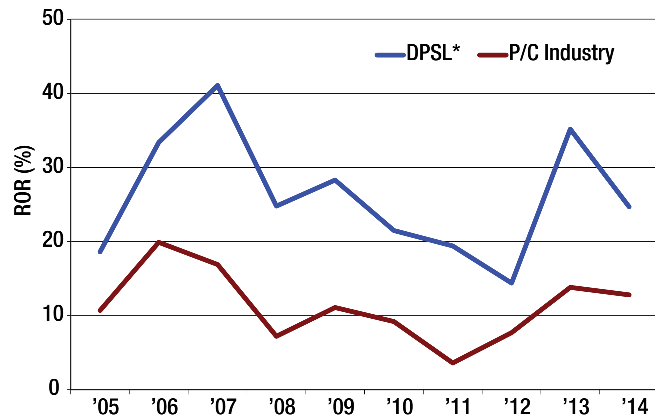
These findings are consistent with A.M. Best's perspective that although the favorable reserve development is supporting underwriting profitability, the magnitude of the support is declining and will continue to dissipate. Commercial auto insurers are already realizing rapidly rising adverse reserve development throughout the P/C industry, while the DPSL composite companies are seeing adverse development across several lines. One main driver of this trend is the ongoing reserve margin tightening amongst surplus lines insurers, reflective of patterns within the overall industry. Insurers that have reserved conservatively will continue to benefit from reserve redundancies and will be better positioned to take advantage of market opportunities through the cycle as others are forced to recognize reserve redundancies, leading to eroding underwriting results and surplus positions.

Exhibit 13
U.S. DPSL* Composite vs. P/C Industry – NPW Growth (1974-2014)



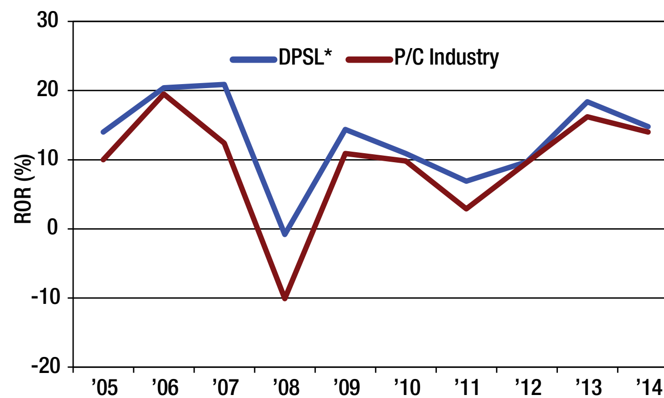
* Domestic Professional Surplus Lines
Source: A.M. Best data and research

Exhibit 14
U.S. DPSL* - Pretax Returns on Net Premiums Earned (NPE) vs. U.S. P/C Industry



* Domestic Professional Surplus Lines
Source: A.M. Best data and research

Exhibit 15
U.S. DPSL* – Total Returns on Surplus vs. P/C Industry



* Domestic Professional Surplus Lines
Source: A.M. Best data and research

DPSL's Growth Rate Less Than Total P/C Industry's

As mentioned earlier, much of the net growth experienced in the DPSL composite in 2014 is connected to the new pooling arrangement of Lexington Insurance Company and AIG. (See **Exhibit 13**.) However, the direct premium writings were unaffected by this arrangement and may serve as the best metric to determine growth throughout the sector. In 2014, the DPSL composite saw direct premium writings increase 3.3%, slightly trailing the overall P/C industry growth of 4.5%. This is the fourth straight year of DPW growth.

Net premium written for the DPSL composite grew 31.3%, compared to the more modest 4.1% growth in the P/C industry. Without the support of Lexington's new pooling arrangement, A.M. Best estimates that NPW growth in the DPSL composite would have been flat, if not slightly negative. The evidence supporting this estimate is the higher growth rate of ceded premiums (12.3% CAGR) compared to gross premiums (9.2% CAGR) over the past five years. As companies take advantage of less expensive reinsurance and continue to optimize their reinsurance placements, this trend likely will continue. It is important to note, however, that a similar trend is occurring throughout the entire P/C industry (3.6% and 3.9% five-year CAGR for gross and ceded premiums, respectively), though to a lesser degree.

Balance Sheet Strength

Given the uniquely hazardous risks that surplus lines companies insure, it is particularly important for these companies to maintain very strong balance sheets. Historically, these insurers have generally

Exhibit 16

U.S. DPSL* - Best's Rating Distribution by Rating Unit vs. U.S. P/C Industry

Best's Financial Strength Rating (FSR)		Domestic Professional Surplus Lines		Total P/C Industry	
Level	**Category**	**# of Rating Units**	**Percentage**	**# of Rating Units**	**Percentage**
RATINGS					
A++	Superior	8	8.79	24	2.75
A+	Superior	21	23.08	81	9.28
	Subtotal	**29**	**31.87**	**105**	**12.03**
A	Excellent	43	47.25	290	33.22
A-	Excellent	18	19.78	285	32.65
	Subtotal	**61**	**67.03**	**575**	**65.86**
B++	Good	1	1.10	94	10.77
B+	Good	0	-	59	6.76
	Subtotal	**1**	**1.10**	**153**	**17.53**
Total Ratings		**91**	**100.00**	**833**	**95.42**
FAIR & BELOW RATINGS					
B	Fair	0	-	25	2.86
B-	Fair	0	-	7	0.80
	Subtotal	**0**	**-**	**32**	**3.67**
C++	Marginal	0	-	1	0.11
C+	Marginal	0	-	3	0.34
	Subtotal	**0**	**-**	**4**	**0.46**
C	Weak	0	-	3	0.34
C-	Weak	0	-	1	0.11
	Subtotal	**0**	**-**	**4**	**0.46**
D	Poor	0	-	0	-
E	Under Regulatory Supervision	0	-	0	-
F	In Liquidation	0	-	0	-
	Subtotal	0	-	0	-
Total Fair & Below Ratings		**0**	**-**	**40**	**4.58**
Total Rating Opinions		**91**	**100.00**	**873**	**100.00**
Total NR Ratings		**4**		**970**	
Total Reported Rating Units		**95**		**1,843**	

*Domestic Professional Surplus Lines
1 Domestic professional surplus lines ratings are as of August 11, 2015
2 Total industry ratings distribution data is as of June 26, 2015
Source: A.M. Best data and research

remained very well capitalized and have continued to maintain this strength through 2014, providing flexibility in the quickly-evolving surplus lines sector.

In 2014, the DPSL composite's policyholder surplus declined by 1.7%, despite generating $2.8 billion in net income. Though reinforced by unrealized capital gains, bringing the composite's total return to $3.4 billion, these earnings were more than offset by $3.2 billion in dividends to holding companies to support stockholder dividends and share buybacks.

By comparison, in 2013 the P/C industry and DPSL composite both experienced turnaround years, generating a 68.7% and 120.4% increase in net income, respectively. Despite this immense growth in the DPSL composite, policyholder's surplus declined 1.2%. A.M. Best believes this speaks to the segment's balance sheet strength, as these companies have capitalized themselves well enough to pay dividends on their earnings.

Exhibit 17

DPSL Peer Composite – Top 5 Product Lines (2014)

Ranked by direct premiums written.
(USD Thousands)

Rank	Product Line	Surplus Lines DPW	DPSL Peer Composite Market Share (%)
1	Other Liability	7,333,953	46.1
2	Fire	1,844,219	11.6
3	Allied Lines	1,565,946	9.8
4	Commercial MultiPeril	1,016,829	6.4
5	Inland Marine	948,412	6.0
	Subtotal of Top 5	**12,709,359**	**79.9**
	Total DPSL Peer Composite	**15,909,089**	**100.0**

Note: "Other Liability" consists primarily of commercial occurrence and claims made general liability policies.
Source: A.M. Best data and research

The DPSL composite continues to maintain generally lower leverage than the total P/C industry, with the exception of ceded leverage, which is slightly higher than the P/C industry average. Despite the marginal difference in ceded leverage, the use of affiliated reinsurers by the composite and total P/C industry are comparable at 86.2% and 85.0% of premiums, respectively. The composite's net leverage of 2.0 times surplus registers a shade below the total industry average of 2.3 times surplus. Because of the DPSL composite's slightly higher ceded leverage of .8 times surplus compared to the industry average of .5 times surplus, the two have equivalent gross leverage of 2.8 times surplus.

Further supporting the composite's strong risk-adjusted capitalization is its conservative investment portfolio, with U.S. government and NAIC Class 1 bonds still constituting the vast majority of the portfolios. Likewise, durations consciously are being kept short in anticipation of an eventual rise in interest rates.

Section III: Regulation and Legislation

One of the first acts of the 114th Congress was the passage of the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA) to reinstate the federal Terrorism Risk Insurance Program, which expired December 31, 2014. (See **Exhibit 18.**) President Obama signed TRIPRA into law on January 12, 2015, extending the federal terrorism program until December 31, 2020. Key revisions to prior provisions included:

- Federal share reduces from 85% to 80% (1% per year)
- Program trigger increases from USD 100 million to USD 200 million (USD 20 million per year)
- Industry's aggregate retention increases from current USD 27.5 billion to USD 37.5 billion (USD 2 billion per year) and Treasury's recoupment rate increases from 133% to 140%.

Exhibit 18
Federal Terrorism Backstop

Terms	TRIPRA (Previous Program)	TRIPRA Reauthorization Act of 2015 (H.R.26, Current Program)
Status		Enacted into law
Extension	NA	5 years to December 31, 2020.
Co-Participation	15%	Beginning on January 1, 2016, Co-Participation will increase 1% annually to 20%
Deductible	$27.5 billion	$27.5 billion, increasing annually by $2 billion to $37.5 billion in the year 2020.
Trigger	$100 million	$100 million, rising by $20 million to $200 million by 2020.
Recoupment	133%	Increase from 133% to 140%
Timeline for Certification	Not Specified	5 years

Source: A.M. Best research
Terrorism Risk Insurance
Program Reauthorization Act (TRIPRA) of 2015 and the Flood Insurance Reform Act, are measures that would reauthorize and modify existing federal programs.

The TRIPRA extension also included the long-anticipated adoption of the National Association of Registered Agents and Brokers (NARAB II). The insurance industry lobbied many years for NARAB in an effort to streamline the licensing process for agents and brokers nationwide and eliminate burdensome multistate requirements while preserving important state regulatory authority and consumer protections in nonresident licensing. NARAB will not become operational until the President appoints a Board, which must be confirmed by the Senate. The Board will consist of eight regulators and five industry members, with three of the industry members representing the P&C industry. After establishing the Board, it is expected to be one to two years before NARAB issues its first national license as the Board is tasked with adopting rules and requirements for internal operations and licensing. Although this is a federally created Board, the states maintain their regulatory and disciplinary authority.

The chart below summarizes recent federal and state legislative and regulatory proposals that could affect the surplus lines industry.

2014-2015 Federal Legislation/ Regulation

Bill/Sponsor	Key Provisions & Actions
Terrorism Risk Insurance Program Reauthorization Act (TRIPRA)	Before September 11, 2001, insurance coverage for losses as a result of a terrorist attack was included in general insurance. After the attacks, such coverage became very expensive, if offered at all. Congress responded to this disruption by passing the Terrorism Risk Insurance Act of 2002, providing a government reinsurance backstop so commercial insurers would offer terrorism coverage. The lack of available insurance caused fears of a major impact on the economy, as companies would remain idle due to uncertainty. The act – extended and amended in 2005 and 2007 and now known as the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) – expired on December 31, 2014.
H.R. 26 TRIP Reauthorization Act of 2015 (Current Program)	On January 12, 2015, President Obama signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2015, which extends TRIP to December 31, 2020 and revises several features of the previous program. Beginning January 1, 2016,The federal share of payments will be reduced by 1% annually to 80% of insured losses from acts of terrorism. The Aggregate industry insured loss trigger will increase stepwise from $100 million in 2015 to $200 million for 2020 and requirements for mandatory recoupment from insurers receiving federal financial assistance will be revised; the recoupment threshold increases $2 billion annually, up to $37.5 billion, and then by a specified formula, while the terrorism loss risk-spreading premium increases from 133% to 140%. Finally, a recoupment in case uncompensated losses surpass aggregate market retention totals is now mandatory. Improvements to the program under this act include the requirement of both the Secretary of the Treasury and the Secretary of Homeland Security to certify an "act of Terrorism", tasking the Secretary of the Treasury to study and issue final rules governing the process for certifying an act of terrorism, and assignment of the GAO to study federal assessment and collection of upfront premiums and the creation of a capital reserve fund to house prepaid capital. The Act calls for the appointment of at least one member to the Board of Governors of the Federal Reserve, experienced with community banks having less than $10 billion in assets, the appointment of an advisory committee to facilitate the creation of non-governmental risk-sharing mechanisms to support private market reinsurance capacity, specific congressional information and reporting requirements for participating insurers, as well as biennial study on the competitive challenges facing small participating insurers.
H.R. 26, Title II National Association of Registered Agents and Brokers Reform Act of 2015 (NARAB II)	The National Association of Registered Agents and Brokers (NARAB) Reform Act of 2015 was enacted on January 12, 2015 as part of the Terrorism Risk Insurance Program Reauthorization Act of 2015. NARAB will streamline agent and broker licensing for those operating on a multi-state basis. It creates a nonprofit board governed by a panel of state insurance regulators and industry representatives to create rigorous standards and ethical requirements with a goal of applying licensing, continuing education and nonresident insurance producer standards on a multi-state basis. With a focus on nonresident licensing, agents or brokers applying for a national license through NARAB will first be required to hold a current license in their home state, pass a national criminal background check and meet the criteria established by the Board, which shall include standards for personal qualifications, educational training and professional experience. The President, with the advice and consent of the U.S. Senate, will appoint the 13 Board members (8 regulators and 5 industry members). Before becoming operational, the board must first establish the rules, requirements and procedures, as well as a national licensing clearinghouse. NARAB is not expected to become operational for a while, with most observers believing it will most likely happen in about two years. • Title II establishes NARAB without contingencies, prohibits NARAB from merging or operating as an insurer/producer, establishes presidential oversight of the NARAB, precludes Federal Funding of NARAB, and also establishes criteria for the board of directors, as well as operational parameters. The Act maintains NARAB's state regulatory jurisdiction regarding consumer protection, market conduct, and state disciplinary authority. • Title II grants NARAB disciplinary enforcement powers, and requires NARAB to establish procedures for multi state qualifications and oversight of non-NARAB insurance producers. • Title II directs NARAB to establish fairness and eligibility criteria and standards to join and maintain membership with NARAB, including criminal history record checks.

• Title II prescribes procedures for authorized and required information sharing for both NARAB and its members, establishes authorized business practices based on NARAB membership, equivalent to a nonresident insurance producer license, establishes continuing education requirements for members by sources other than NARAB, as well as consumer complaint management.

• Finally, Title II authorizes civil action by aggrieved individuals resulting from a NARAB decision or action, and minimally preempts state laws that regulate insurance producers.

Bill/Sponsor	**Key Provisions & Actions**
Flood Insurance Reform Act of 2012	The Biggert-Waters Flood Insurance Reform Act of 2012 was passed by Congress and signed by the President in 2012. It extended the National Flood Insurance Program (NFIP) for five years, while requiring significant program reform.
The following bills were introduced in the 113th Congress in:	Concern about increased premium rates resulting from Biggert-Waters caused Congress to reconsider its implementation. The House and Senate ultimately both passed bills to reverse some of the changes brought about by Biggert-Waters.
October 2013:	
H.R. 3370, by Rep. Michael Grimm (R-NY)	H.R. 3370, the Homeowner Flood Insurance Affordability Act of 2014, required the NFIP to consult with "Write Your Own" companies on rate tables, capped the annual increase for the chargeable risk premium rate for flood insurance to 18% (with some exclusions), and required an increase in the chargeable flood insurance risk premium rates for certain properties. It directed FEMA to minimize the number of policies with annual premiums exceeding 1% of the total policy coverage, imposed an annual premium surcharge, beyond existing assessments and surcharges, on new or renewed policies, and draft a framework that addresses flood insurance affordability, via programmatic and regulatory change. This legislation was signed into law in March 2014. Finally, H.R. 3370 required a review of the NFIP flood mapping program to ensure accurate flood hazard data.
March 2014:	
H.R. 4313, by David Jolly (R-FL)	H.R.4313, the Flood Insurance Premium Parity Act of 2014, amended the National Flood Insurance Act of 1968 (NFIA) to prohibit the Administrator FEMA from estimating reduced (subsidized) risk premium rates for flood insurance for residential property that is neither the primary residence of an individual (as under current law) nor the secondary residence of the property owner. It also directed FEMA to establish standards for a residential property to qualify as a secondary residence eligible for subsidized risk flood insurance premium rates that require the owner to occupy the property for an appropriate minimum period of time each year, and limit subsidized risk premium rates to but a single property of the owner. H.R. 4313 sought to repeal the prohibition against estimating subsidized risk premium rates for business property (thus qualifying business property for such rates) and directed FEMA to refund directly to insureds any flood insurance premiums collected in excess of the rates required under this Act. This legislation was not enacted.
May 2014:	
H.R.4558 and S.2381, by Rep. Dennis Ross (R-FL) and Rep. Patrick Murphy (D-FL) and Sen. Dean Heller (R-NV) and Sen. Jon Tester (D-MT).	H.R.4558 and S. 2381, the Flood Insurance Market Parity and Modernization Act, introduced in May 2014, would ensure that surplus lines insurers are eligible to offer private market solutions and alternatives to consumers needing coverage of unique and complex flood risks. This legislation was not enacted but has been filed again in 2015.
June 2015:	
H.R 2901/S. 1679, by Rep. Dennis Ross (R-FL), Rep. Patrick Murphy (D-FL) and Sen. Dean Heller (R-NV) and Sen. Jon Tester (D-MT)	H.R.2901/S. 1679, the Flood Insurance Market Parity and Modernization Act will provide clarity to lenders that they may accept private flood insurance solutions from the surplus lines market, just as they had prior to the Biggert-Waters Act of 2012.

2014/2015 State Level Legislation/Regulation

State Legislation	The following are bills proposed or enacted at the state level regarding surplus lines:
Kansas	HB 2352 (formerly SB 155) has been signed by the Governor on June 5, 2015. This critical legislation eliminates the requirement to tax multistate risks at other states' rates. Effective January 1, 2016, all surplus lines premium where Kansas is the home state of the insured shall be taxed 100% at Kansas's rate of 6%. Kansas was one of seven states that continued to tax multistate risks at multiple states' rates, although they retained 100% of the tax. Kansas now joins the majority of states that have fully implemented the home state tax approach as envisioned under the NRRA. The legislation also rescinded Kansas's participation in the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT). Having failed to reach the required ten member states, SLIMPACT never became operational.

Louisiana	HB 259, passed by the Louisiana legislature on June 12, 2015 and signed into law by the governor on July 1, 2015, removes the requirement for the state to participate in the Nonadmitted Insurance Multistate Agreement (NIMA), allowing the Commissioner to withdraw effective October 1. The new law will also reduce the surplus lines premium tax from 5% to 4.85% and, when Louisiana is the home state, taxes 100% of the premium regardless of where the risk is located. Additionally, the law revises the required "zero premium" report from a quarterly to an annual filing.
North Dakota	HB 1146, signed by the Governor on March 20, 2015, eliminates the requirement to tax multistate risks at other states' rates. Effective June 1, 2015, all surplus lines premium where North Dakota is the home state of the insured shall be taxed 100% at North Dakota's rate of 1.75%. North Dakota was one of seven states that continued to tax multistate risks at multiple states' rates, although they retained 100% of the tax. North Dakota now joins the majority of states that have fully implemented the home state tax approach as envisioned under the NRRA. The legislation also rescinded North Dakota's participation in the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT). Having failed to reach the required ten member states, SLIMPACT never became operational. SB 2187, signed by the Governor on March 26, 2015, standardized the date for tax filings and payments. Prior law required taxes to be filed before May 1 and annual tax statements to be filed on or before April 1. Effective June 1, 2015, both taxes and the annual tax statement will be filed by March 1.
Utah	SB 212 was enacted on March 26, 2015 and repeals HB 129, which passed in March 2014, and required surplus lines insurers to initiate an audit within six months of expiration of the policy and prohibited surplus lines insurers from counting as earned premium an amount in excess of 50% of the initial premium.
State Reporting Changes	**The following states issued bulletins or legislative changes regarding surplus lines taxes:**
Arizona	HB 2342 was passed to clarify the role and voting procedures of the Surplus Line Association. It originally included language to clarify that for group insurance contracts, the home state is the state of incorporation or organization of the group, however, this provision was removed before passage.
California	SB 585 will require insurers, including nonadmitted, to notify the Department of Child Support Services if a claim is owed to any person owing a duty of child, spouse of family support. The Department of Insurance is charged with creating a system and regulatory guidance for use by insurers. The legislation is currently awaiting hearing in the Assembly Insurance Committee.
Colorado	Bulletin No. B-2.10: This bulletin was issued to clarify standards for taxation based upon changes that were made to the Colorado statute in 2012 to implement the NRRA.
Connecticut	HB 6865 was passed on June 2, 2015 and required nonadmitted insurance policies to include the definition of depreciation per C.S.A §38a-307 when a coinsurance clause is issued. The surplus lines industry opposed the legislation with significant concerns that it imposed form requirements on nonadmitted policies as well as limiting application to the nonadmitted market. The legislation narrowly passed both chambers and a number of industry members requested the Governor veto the measure, which he did on June 30. HB 6771 permits nonadmitted insurers to establish an office in Connecticut for the lawful transaction of surplus lines insurance. The legislation takes effect October 1, 2015.
Delaware	HB 40 was signed by the Governor on June 4, 2015 to remove the notarization requirement for diligent search broker affidavits. The documents are now considered written statements to be retained in the broker's files.
Florida	HB 252 provided that the absence of a countersignature on a policy does not affect the validity of a surplus lines policy and became effective July 1, 2015. SB 1094 revised the existing statute to specifically require agents placing coverage outside of the National Flood Insurance Program (NFIP), including surplus lines polices, to obtain acknowledgement from the applicant that if the applicant discontinues coverage under the NFIP that is provided at a subsidized rate, the full risk rate for flood insurance may apply to the property if the applicant later seeks to reinstate coverage under the program. The legislation also became effective July 1, 2015. It should be noted that the underlying statute allows a surplus lines agent to export flood coverage to an eligible surplus lines insurer without making a diligent effort. This exemption is set to expire on July 1, 2017.
Illinois	SB 1573 would repeal provisions of 2014's SB 3324, which deleted language for the industrial insured exemption; however, the bill is still pending and it is considered unlikely to pass. The Department of Insurance issued a bulletin regarding the definition of industrial insured on June 18, 2015.

State	Activity
Kansas	SB 145 was the only legislative activity regarding insurer eligibility during this legislative session, but failed to be adopted. This bill would have revised the definition of eligible insurer to conform to the definition and intention of the NRRA and would have removed the requirement of appearing on an eligibility list, but would have allowed the commissioner to maintain a voluntary list. The Department has indicated it is willing to discuss the industry's concern with the current eligibility listing requirements in the near term.
Louisiana	Bulletin 2015-06: On July 15, 2015 the Department of Insurance issued Bulletin 2015-06, also effective October 1, 2015, to provide guidance to the industry on how to report and file taxes under the both prior to and after the state withdraws from NIMA and the revised tax mechanism becomes effective. HB 214 creates a domestic surplus lines insurer (DSLI). This law becomes effective on August 1, 2015.
Maryland	Bulletin 15-12: A request for Maryland surplus lines brokers to provide the data regarding claims relating to the Baltimore City Civil Unrest pursuant to Maryland Insurance Code §§2-206(1) and 3-322. Data shall be submitted for each surplus lines company the surplus lines broker represents, by line of business, for the City of Baltimore using the link to the Severe Event Data Collector. SB 868 was signed by the Governor on May 12. This legislation addressed requirements for Transportation Network Companies (TNC) operating in the state. The legislation originally proposed specific rate and form approval for surplus lines insurers, which industry members strongly opposed. Work with the Department of Insurance and legislature successfully resulted in alternative language so that surplus lines insurers are not required to file TNC policies with the Department; rather, the Public Utilities Commission may request a copy of the policy for review prior to approving the TNC's license to operate in the state. HB 565 is enacted legislation that authorizes the use of surplus lines insurance for disability insurance coverage under specified circumstances and provides that the procurement of specified disability insurance through surplus lines insurance is subject to specified requirements. The law will take effect October 1, 2015.
Massachusetts	SB 479 would establish hybrid personal injury protection policies as an option to fulfill required coverage in Massachusetts. The bill contemplates that nonadmitted insurers may also file such a form. The legislation is still pending.
Michigan	HB 4532 was filed on April 28, 2015 in Michigan to revise some statutes related to NRRA. The legislation remains pending.
Minnesota	HB 177 takes effect on August 1, 2015 and will regulate self-service storage facilities and require them to obtain insurance that may be obtained through a surplus lines company. In May, the Minnesota Joint Underwriting Association attempted to assess surplus lines companies as part of their guaranty assessment but issued a stay after discussions with surplus lines industry trade associations.
Mississippi	SB 2254 exempts from premium taxes the surplus lines policies procured by the Mississippi Department of Administration. The bill became effective July 1, 2015.
Montana	HB 94 was enacted on February 24th to allow natural disaster multi-peril insurance to be sold as surplus lines insurance; HB 240 was enacted on April 10th to remove prohibition of surplus lines policy fees, but limits the fee to $50 for personal lines and $100 for commercial lines.
New Jersey	The New Jersey Department responded to comments that interested parties submitted last August on changes to Regulation 11:19-3.1 through 3.5 that were adopted April 21. The Regulation became effective May 18 and pertains to requirements of the new electronic filing system for surplus lines transactions. The Department declined to make many changes based on the comments they received and the final regulation remains similar to the original proposal.
New York	Insurance Reg. 41 (11 NYCRR Part 27): Titled the Proposed 14th Amendment to Insurance Regulation 41, this amendment applies to the excess line placements governing standards to conform to the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA). On October 8, 2014, the New York Department of Financial Services (DFS) adopted their proposed amendments to Regulation 41. This regulation details the state's standards governing surplus lines placement in New York. The amendments incorporate changes in the standards related to the NRRA. AB 9590 was signed by the Governor on January 29, 2015 and prevents third parties from demanding the issuance of a Certificate of Insurance (COI) that goes beyond simply demonstrating proof that insurance coverage has been placed. AB 4616 was signed by the Governor on March 13 and requires Certificates of Insurance on policies for Personal Injury Liability or Property Damage Liability to be issued on a form promulgated by the insurer or a form approved by the Department.

State	Legislation
Nevada	AB 486 removes statutory fees for surplus lines companies ($1,300 annually) and removes mandatory $15 Insurance Recovery Account fee for surplus lines brokers and replaces it with an assessment of $10 to be imposed by the Commissioner only after the Insurance Recovery Account falls below $40,000. The bill became effective July 1, 2015.
North Carolina	HB 262 authorized the creation of the North Carolina Stamping Office, making it the 15th stamping office in the nation. The legislation is expected to take effect within 60 days of adjournment, which is projected to be around July 26, 2015.
Oklahoma	SB 487 became effective April 10 and removes diligent search effort requirements in the procurement of flood insurance through surplus lines insurers.
Oregon	SB 935 became effective on June 18 and exempts wet marine and transportation insurance from the requirement to obtain certificate of authority. The Division adopted O.A.R. 836-010-0026 in March which prohibits the use of discretionary clause language in insurance contracts for all lines of insurance.
Pennsylvania	SB 736, if passed, will regulate self-service storage facilities and will allow the required insurance to be obtained through a surplus lines insurer.
South Dakota	HB 1088 became effective February 24th and amends prior law to allow surplus lines insurers to provide excess disability insurance.
Tennessee	SB 82 becomes effective January 1, 2016 and requires broker affidavits to be filed within 30 days of issuing a policy. Prior to enactment of the law, affidavits were to be issued at the end of each month. Additionally, effective February 16, the Department began using OPTins for electronic payments for surplus lines premium tax
Texas	HB 409 would have required liquor licensees to carry liquor liability insurance. This type of insurance is not currently required. The bill would have allowed the coverage to be provided from an admitted or eligible surplus lines insurer but failed to pass out of the House. HB 686 related to insurance agents' ownership and use of information related to the expiration of property and casualty insurance policies. The proposed bill would have allowed an agent the exclusive ownership and use of an "expiration" directly related to an insurance application submitted by or an insurance policy written through that agent for the purpose of soliciting, selling or negotiating the renewal or sale of the coverage. The bill failed to pass out of committee. HB 2947 was sought to revise diligent search requirements. The bill was proposed as a compromise based on indications from the Department on their intent to revise regulations regarding the requirements. Ultimately the Department decided not to change the current procedure and the legislation was allowed to die.
Virginia	HB 1745 became effective July 1, 2015, and increases the maximum assessment of fire insurance companies, including surplus lines policies, for the Fire Programs Fund from .01 to .025%.
Washington	HB 1308 clarified that the portion of a risk located outside of the U.S. is exempt from surplus lines premium tax. The law has been signed by the Governor and became effective July 24, 2015.
Wisconsin	OCI Bulletin 05-14: This bulletin informs surplus lines insurers of changes to filing requirements, effective July 1, 2014. This is the result of the Wisconsin Office of the Commissioner of Insurance (OCI) declining to join the Nonadmitted Insurance Multi-State Agreement, Inc. (NIMA) as a full member.

Sources: Library of Congress, National Association of Professional Surplus Lines Offices, Ltd. (NAPSLO) and individual states' legislative websites.

Update on the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA)

The NRRA was passed as a provision of the Dodd-Frank Wall Street Reform Act of 2010 (DFA). Some leaders, and other members of the 114th U.S. Congress, have stated that revisions and repeals of provisions of the DFA are a high priority, but the NRRA has not been identified as a specific target in these discussions.

Similar to what was reported in the 2014 segment review, as of 2015, all states except Michigan, as well as the District of Columbia, have adopted specific NRRA implementation language. Both of those jurisdictions, however, follow the NRRA in practice and continue to comply with the NRRA's home state tax approach. The NRRA, which was passed by Congress in July 2010 and took effect one year later, resulted in the following reforms related to surplus lines/nonadmitted insurance:

- Limited the regulation and taxation of surplus lines/nonadmitted transactions to only one state – the home state of the insured, meaning the state where a commercial insured's principal place of business is located, or if the insured is an individual, the individual's state of residence.

- Established uniform, nationwide eligibility standards based on two sections of the National Association of insurance Commissioners' Nonadmitted Model Act for U.S.-domiciled nonadmitted insurers. The model act defines an eligible surplus line insurer as being authorized in its state of domicile to write the coverage being offered on a nonadmitted basis and meeting specified capital and surplus standards. The NRRA also requires states to allow licensed surplus lines brokers to place or procure insurance from any alien (non-U.S.-based nonadmitted insurer) that is on the NAIC Quarterly Listing of Alien Insurers.

- Created a nationwide definition of an exempt commercial purchaser (ECP), applicable in each state, for which a broker can access the surplus lines market without the need of a diligent search being performed.

The simplification of the regulation and taxation of the surplus lines insurance transaction is the key focus, and many feel, the greatest success of the NRRA. The law called on each state to adopt nationwide, uniform requirements, forms and procedures for the reporting, payment, collection and allocation of surplus lines premium taxes and recognized that states may form compacts or other mechanisms to share surplus lines premium taxes paid to an insurer's home state. The home state provision has produced significant benefits for the surplus lines industry by reducing the need for brokers and insurers to comply with differing sets of rules, disclosures and requirements. Effective October 1, 2015, 47 jurisdictions[1], representing 86% of the nationwide surplus lines premium, will retain 100% of the taxes they collect, and effective January 1, 2016, 41 of those jurisdictions will tax 100% of any multistate risk in accordance with the home state's tax rates and rules.

Also effective October 1, 2015, Louisiana will withdraw from the Non-Admitted Insurance Multi-State Agreement (NIMA). In addition to retaining 100% of the taxes collected at their own premium tax rate, they will now also tax 100% of the surplus lines risk, regardless of where it resides. HB 259 was passed during the 2015 legislative session to effectuate these changes. In addition to the above-noted changes, the surplus lines premium tax rate will decrease from 5% to 4.85%.

Only five jurisdictions – Florida, Puerto Rico, South Dakota, Utah and Wyoming – remain in NIMA and continue to share taxes as part of their membership. Tennessee currently participates as an associate member of NIMA and, as a result, requires surplus lines brokers

[1] AK, AL, AR, AZ, CA, CO, CT, DC, DE, GA, HI, IA, ID, IL, IN, KS, KY, LA, MA, MD, ME, MI, MN, MO, MS, MT, NC, ND, NE, NH, NJ, NM, NV, NY, OH, OK, OR, PA, RI, SC, TN, TX, VA, VT, WA, WI, WV

to provide multistate allocation information to NIMA's Surplus Lines Clearinghouse (SLC). Tennessee's associate membership expires on October 1, 2015, and the state will need to decide if it wishes to join NIMA as a full member. Wisconsin participated in the one-year associate membership but on June 25, 2015, declined to join as a full member.

There are five non-NIMA jurisdictions that continue to tax multistate risks at multiple jurisdictions' rates, although they retain 100% of the tax. These jurisdictions include Hawaii, Massachusetts, Nebraska, New Hampshire and Vermont. Prior to the 2015 legislative session, Kansas and North Dakota also required brokers to collect surplus lines premium taxes based on an allocation of risk and at other jurisdictions' rates; however, as of June 1, 2015, North Dakota eliminated this requirement and implemented the 100% home state approach such that when North Dakota is the home state, taxes are calculated and remitted based on its 1.75% tax rate. Kansas passed similar legislation but it does not become effective until January 1, 2016 so brokers must continue, until that time, to calculate the tax based on the premium tax rate where the risk resides.

Along with NIMA, the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) was the other tax-sharing model put forth by various jurisdictions in response to the NRRA. Nine jurisdictions initially adopted SLIMPACT; however, it failed to become operational as it never secured the required tenth member. Three states have withdrawn from SLIMPACT, including Kansas, North Dakota and Tennessee, leaving only six states in the non-operation agreement (Alabama, Indiana, Kentucky, New Mexico, Rhode Island and Vermont). No SLIMPACT states are pushing to make the compact operational and it is believed more states will eventually eliminate the law from their statutes and simply continue to follow the home state approach they already use.

The NRRA also addressed insurer eligibility and provided clear criteria for determining an insurer's eligibility to provide surplus lines insurance in each state. While some states have eliminated many pre-NRRA eligibility requirements such as "white lists," a number of states continue to impose eligibility requirements beyond those outlined in the NRRA. Since the 2014 report, no states have taken legislative or regulatory action to eliminate these additional requirements.

The NAIC's International Insurers Department Quarterly Listing of Alien Insurers has become the accepted regulatory source for establishing eligibility for alien (non-U.S.) insurers that appear on the list as required by the NRRA. The list is maintained by the National Association of Insurance Commissioners (NAIC), and provides brokers, exempt commercial purchasers, and insureds with assurance concerning the eligibility of non-U.S. insurers being utilized to quote or place excess and surplus lines insurance business.

On January 1, 2015, the criteria used to qualify as an ECP were required by the NRRA to be adjusted based on the Consumer Price Index (CPI). The NAIC subsequently recommended to states that the ECP criteria be adjusted as follows:

Criteria	Pre-2015	Post-2015
Net Worth	USD 20,000,000	USD 22,040,000
Annual Revenues	USD 50,000,000	USD 55,100,000
Annual Budgeted Expenditures	USD 30,000,000	USD 33,060,000

It was not the intent of the NRRA to have any effect on prices or the availability of coverage. Based on the information in the 2014 Government Accountability Office report on the effects of the NRRA, market participants have stated that the NRRA has indeed had little, if any, effect

on the prices or availability of coverage. According to the surplus lines insurers contacted by the GAO, the NRRA has caused little noticeable shifting in coverage between the admitted and surplus lines markets, which, again, was not the intent of the legislation.

Federal Flood Insurance Legislation

In June of 2015, lawmakers introduced a bipartisan measure, the Flood Insurance Market Parity and Modernization Act, designed to clarify provisions of the National Flood Insurance Program (NFIP) to ensure private market flood insurance solutions are accepted by lenders. The law would clarify that lenders may accept coverage either alternatively or in addition to that made available through the NFIP in order to meet the mandatory purchase requirements of the National Flood Insurance Act in 42 U.S.C.A §4012a. This legislation is important to surplus lines insurers in order to preserve the coverages they historically provided, as well as to modernize the definition of private flood insurance to reflect the "eligible insurer" and "home state" terminology adopted in federal law through the NRRA.

The bipartisan bill was introduced by Representatives Dennis Ross (R-FL) and Patrick Murphy (D-FL) and Senators Jon Tester (D-MT) and Dean Heller (R-NV). A similar bill was introduced last year, but failed to pass.

Section IV – Current Distribution Trends

Surplus lines coverage solutions emerge when the standard market cannot provide needed coverages. As new exposures arise, the surplus lines market often provides the best, or sometimes the only, solution for retail producers and insureds seeking coverage for these exposures. It was only a few years ago that drones, 3-D printers, and cyber risks were not on anyone's radar screen. In 2015, they are at the forefront of people's minds, including surplus lines professionals. Sharing technologies, such as Uber, and driverless cars can be added to the list of newly emerging risks as well.

Opportunities

With new technologies come new risks, which present an opportunity to provide coverage for those who are looking to protect themselves against these risks. The planned usage of small unmanned aerial vehicles or drones is an example of technology presenting new and unique risks. Drones are being used for property inspections and inspections by insurance claim adjusters, imaging and surveillance applications in law enforcement, search and rescue attempts, and catastrophe response efforts, often obtaining detailed photographs of terrain, homes and people. Risks posed by the use of commercial drones include population safety, property damage, and both security and privacy concerns. It is still to be determined whether the benefits of increased commercial usage of drones are worth the associated risks. Another obvious problem is the already crowded U.S. airspace. From an insurance perspective, surplus lines companies may contribute positively to the resolution of issues related to drones by evaluating the risks and offering solutions to those looking to implement drone technology.

The dawn of 3-D printing is another area that presents opportunities, as well as potential pitfalls. For example, prosthetics can be developed using this technology, and can do wonders for so many people but there also is the risk that they will not work as intended. Who should bear that risk and how should coverage be implemented? In the case of using this technology to develop weapons, specifically non-metallic weapons, there are risks associated with the ability to get non-metallic weapons past metal detectors, creating considerable safety concerns. How such risks are protected against and who bears that risk are issues and questions that still require deep consideration and possibly a few lawsuits to provide clarity.

Cyber threats are a growing loss exposure as well. With mobile devices, information is now at our fingertips 24/7. This may include personal information, medical data, store purchases, bank account information and other confidential material, all of which are enticing targets for cyber criminals. There have been numerous reports of personal data being compromised and this drives up the cost of doing business. Many companies that have previously chosen not to purchase cyber risk insurance are now weighing its importance. Through 2014, approximately 20% of large enterprises carried cyber risk coverage, with an even lower adoption rate among medium- and small-sized enterprises. Cybersecurity threats show no signs of abating; if anything, the opposite is true. Protection against cyber threats is likely to be an increased area of focus, resulting in a significant opportunity that, in terms of insurance, could only be met by surplus lines insurers given the rapidly changing nature and scope of cyber exposures and the state form filing process that admitted insurers are encumbered with. Surplus lines insurers can meet the needs of insureds where standard coverage is insufficient or nonexistent.

Challenges

Competition, consolidation, and pricing are among the primary concerns of producers in the surplus lines space. Surplus lines intermediaries find that some producers are placing

traditionally surplus lines risks in the admitted market. Not surprisingly, current market pricing generally is considered soft to weak due to overcapacity.

NARAB II

The National Association of Registered Agents and Brokers Reform Act of 2015 (NARAB II) was signed into law by President Obama in January 2015 as part of the Terrorism Risk Insurance Program Reauthorization Act of 2015. While it will take a number of years for this to be implemented, the market view is that NARAB II will make it easier for agents and brokers to conduct business and make the licensing process more streamlined. Productivity is expected to improve and the cost of business and compliance to decrease. NARAB II also aims to make it easier for insurers doing business in multiple states.

Business Trends

It's a mixed bag as far as whether surplus lines business is growing or not. Some companies are experiencing slight, more deliberate growth. Other entities report opportunities for across-the-board growth through varied lines of business. Some surplus lines insurers report feeling squeezed as standard lines insurers write more business that was formerly written mainly in the surplus lines market. Still others see flat growth prospects over the near-term that they expect will remain as such, absent a major catastrophe.

Consolidation

The general feeling is that consolidation has only had a limited impact among surplus lines producers, but there is a bigger concern that consolidation will adversely impact existing relationships and response time. There also is concern that fewer alternatives will be available and that quality will give way to price in the decision-making process.

Technology

A major benefit of effective technology is that when well-implemented, it makes it easier for producers to focus on their main goals. Technology also allows for greater mining of data. Ideally, small businesses benefit from new technology by simplifying tasks while larger companies benefit from greater efficiency. It is very important for future success of surplus lines insurers that as technology changes, they are able to keep pace. Insureds will undoubtedly be using even more advanced technologies in the years ahead. Current employees also may need to be trained to use the tools newly available. Depending on the priorities of the insurer, there may be a significant learning curve involved in becoming an expert at using new tools and technologies effectively.

Investment in New Products

The development of new products and programs remains important to surplus lines insurers. One of the hallmarks of the surplus lines insurance market is the development of new insurance solutions to address new or emerging risks, or to provide improved coverage for known risks. New products and programs continue being developed and launched. Some insurers, however, value the importance of investing in one's core products and expanding into other areas in deliberate, circumspect fashion, as opportunities arise.

Section V – Impairment Trends

Following a drop in 2013 to the lowest levels since 2007, financial impairments in the U.S. admitted property/casualty (P/C) industry dropped a little further in 2014, falling to almost one-third of the 2012 impairment count. Year-over-year, the impairment count was down 20% in 2014 and 44% in 2013.

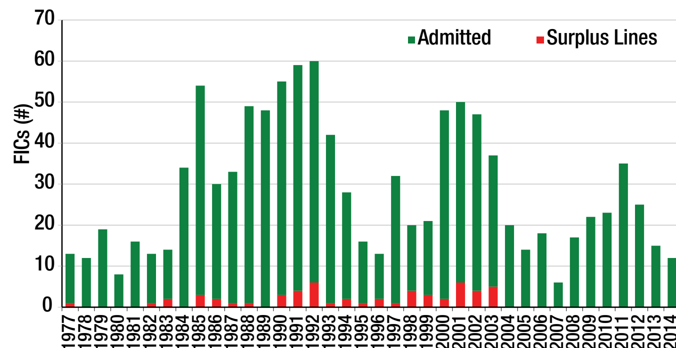
For the 11th consecutive year, the surplus lines industry recorded no financial impairments for the year.

P/C Industry Impairment Experience

The 12 known impairments in 2014 (see **Exhibit 19**), and 15 in 2013, compared with the 25 in 2012, have been more in line with figures seen consistently during the 1970's. A.M. Best assigned ratings to four and reported on seven of the 12 impairments in 2014. Of the companies that were rated, none carried a Secure rating in the year of impairment.

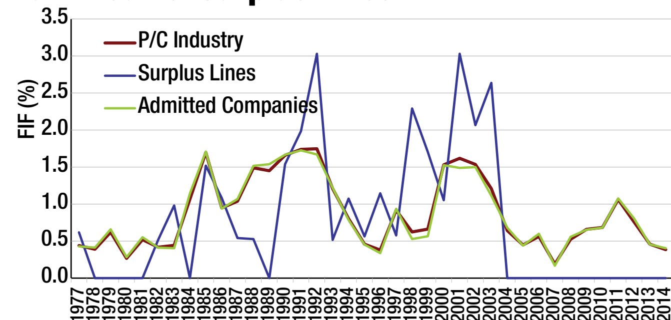
It is possible that additional financial impairments for 2014 and prior years could emerge. There could be a lag in the reporting of impairments due to the increasing use of confidential actions by insurance regulators, who are reluctant to publicly disclose impairments until all possible avenues to rehabilitate or find a buyer for troubled insurers have been exhausted. A.M. Best has found that there is an average 1.5-year lag between a confidential regulatory action and public disclosure of the impairment, usually the time between supervision and liquidation – if the confidential action ever becomes public at all.

Exhibit 19
U.S. Property/Casualty – Annual Impairment Count, Admitted Companies vs. Surplus Lines



Source: A.M. Best data and research.

Exhibit 20
U.S. Property/Casualty – Financial Impairment Frequency, Admitted vs. Surplus Lines



Source: A.M. Best data and research, BestLink Best's Statement File – P/C, U.S.

The financial impairment frequency (FIF) is calculated using the number of companies that become impaired in a given year, divided by the number of companies operating in the insurance market in that year. A.M. Best believes the FIF is a more accurate indicator of impairment trends than a simple count. The P/C industry's 2014 FIF was 0.39, below the industry's historical average of 0.91. Reviewing the most recent ten-year-term, the 2011 FIF of 1.06 seems to have marked the peak for impairment frequency, after the 2007-2010 soft-market trough and the 2007-2009 recession.

A.M. Best has found that, historically, increases in the insurance industry's FIF correlate strongly with preceding negative operating environments marked by events such as stock market booms and busts; economic recessions; and extraordinary catastrophe losses that typically force the end of soft markets (see **Exhibits 20 and 21**). Evidence of these trends resides in the increased FIF rates during the periods 1988 to 1993 and 2000 to 2003.

Surplus Lines Impairment Experience

Despite the absence of surplus lines financial impairments from 2004-2014, the industry's failure frequency rate of 0.86% from 1977 to 2014 remains close to the admitted company average of 0.91%. This reflects the surplus

Exhibit 21

U.S. Property/Casualty – Financially Impaired Companies Count & Frequency Industry vs. Surplus Lines.

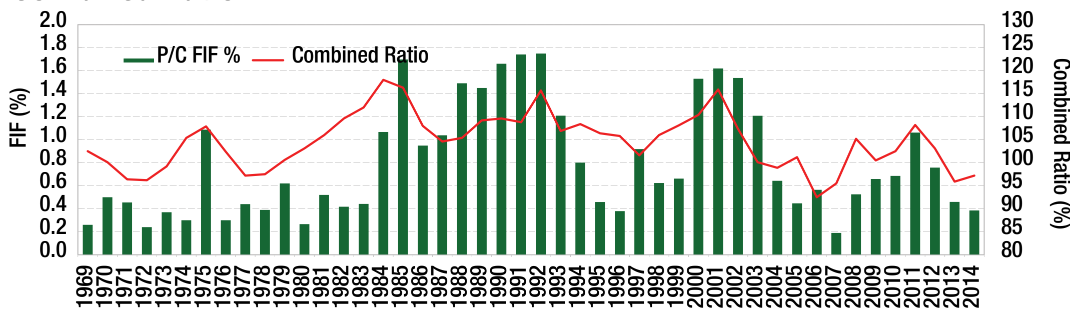
	Financially Impaired Companies (FIC)			Financial Impairment Frequency (FIF)[2]		
Year	P/C Industry	Surplus Lines	Admitted Cos.[1]	P/C Industry	Surplus Lines	Admitted Cos.[1]
1977	13	1	12	0.44	0.62	0.43
1978	12	0	12	0.39	0.00	0.41
1979	19	0	19	0.62	0.00	0.66
1980	8	0	8	0.27	0.00	0.28
1981	16	0	16	0.49	0.00	0.55
1982	13	1	12	0.42	0.52	0.41
1983	14	2	12	0.44	0.98	0.40
1984	34	0	34	1.13	0.00	1.14
1985	54	3	51	1.54	1.52	1.54
1986	30	2	28	0.95	1.08	0.94
1987	33	1	32	1.04	0.54	1.07
1988	49	1	48	1.49	0.53	1.55
1989	48	0[3]	48	1.45	0.00	1.54
1990	55	3	52	1.66	1.54	1.67
1991	59	4	55	1.77	1.99	1.76
1992	60	6	54	1.72	3.03	1.64
1993	42	1	41	1.21	0.52	1.25
1994	28	2	26	0.80	1.08	0.79
1995	16	1	15	0.46	0.56	0.45
1996	13	2	11	0.38	1.15	0.34
1997	32	1	31	0.92	0.58	0.94
1998	20	4	16	0.62	2.29	0.53
1999	21	3	18	0.66	1.70	0.60
2000	48	2	46	1.53	1.05	1.56
2001	50	6	44	1.62	3.03	1.52
2002	47	4	43	1.54	2.07	1.50
2003	37	5	32	1.21	2.64	1.11
2004	20	0	20	0.64	0.00	0.68
2005	14	0	14	0.45	0.00	0.47
2006	18	0	18	0.56	0.00	0.60
2007	6	0	6	0.19	0.00	0.20
2008	17	0	17	0.53	0.00	0.56
2009	22	0	22	0.66	0.00	0.69
2010	23	0	23	0.68	0.00	0.71
2011	35	0	35	1.06	0.00	1.11
2012	25	0	25	0.76	0.00	0.81
2013	15	0	15	0.46	0.00	0.49
2014	12	0	12	0.39	0.00	0.40
1977-2014	**1078**	**55**	**1023**	**0.88**	**0.79**	**0.88**

1 Includes alternative markets.
2 Failure frequencies are annualized rates.
3 1989 figures have been adjusted from previous reports to exclude 7 U.K.-domiciled companies.
Source: A.M. Best data and research

lines industry's significantly higher impairment frequencies during certain periods, in particular, 1992, 1998, 1999 and 2001-2003. (See **Exhibit 21.**) Since 2003, with each year that the surplus lines industry has experienced no financial impairments, the historical impairment frequencies for admitted and surplus lines companies have been steadily converging. The failure frequency rate is calculated using the number of companies that become insolvent in a given year, divided by the numberof companies operating in the insurance market in that year.

Exhibit 22

U.S. Property/Casualty – Financial Impairment Frequency vs. Industry Combined Ratio*



*Combined ratios are after policyholders' dividends. A combined ratio below 100 indicates an underwriting profit; above 100, an underwriting loss.
Source: A.M. Best data and research

The primary reason for the absence of surplus lines insurer failures in the mid-2000's related primarily to the surplus lines industry's improved underwriting performance, driven by demonstrated underwriting discipline and adequate pricing, overall. Investments in advanced technologies and improved systems, along with better management reporting and more robust oversight have also helped the impairments to trend positively for surplus lines insurers.

Beginning in 2007, however, underwriting profitability and operating performance began a period of deterioration that lasted through 2012, as indicated by a rise in the surplus lines industry's combined ratio (see **Exhibit 23**), before improvements were recorded in 2013 and again in 2014. For that reason, the absence of impairments in the late 2000's and early 2010's was initially more related to the overall capitalization of surplus lines companies than to underwriting performance. The improvement in profitability in the most recent years should also contribute to the likelihood that the recent impairment trend for surplus lines companies remains favorable.

A.M. Best remains optimistic, but guardedly so, about the low trend of surplus lines impairments with the offsetting factors specifically related to sluggish or, in some cases, weak economic conditions that have prolonged the soft market and contributed to pressure on combined ratios. The persistent low interest rate environment limits the ability of surplus lines (and admitted) companies to potentially withstand or offset any deficiencies in pricing or inadequate risk selection with investment returns and capital market gains.

Causes and Characteristics of Financial Impairments

The causes and characteristics of financial impairments have generally remained consistent for both the surplus lines and admitted P/C industries during the period that A.M. Best has examined impairment data, most recently updated in the special report, *U.S. Property/Casualty – Impairment Review* (August 2015).

Deficient loss reserves/inadequate pricing and rapid growth have accounted for the largest portion of total impairment among surplus lines and admitted companies. (See **Exhibits 24 and 25.**) These two categories in combination

Exhibit 23

U.S. DPSL* Composite – Financial Impairment Frequency & Combined Ratio

Year	FIF	Combined Ratio
1997	0.58	93.8
1998	1.72	98.5
1999	1.70	99.8
2000	1.05	105.0
2001	3.54	105.3
2002	2.07	93.0
2003	2.64	92.2
2004	0.00	93.5
2005	0.00	93.2
2006	0.00	79.4
2007	0.00	76.1
2008	0.00	93.6
2009	0.00	93.1
2010	0.00	100.5
2011	0.00	105.1
2012	0.00	110.5
2013	0.00	92.4
2014	0.00	88.8

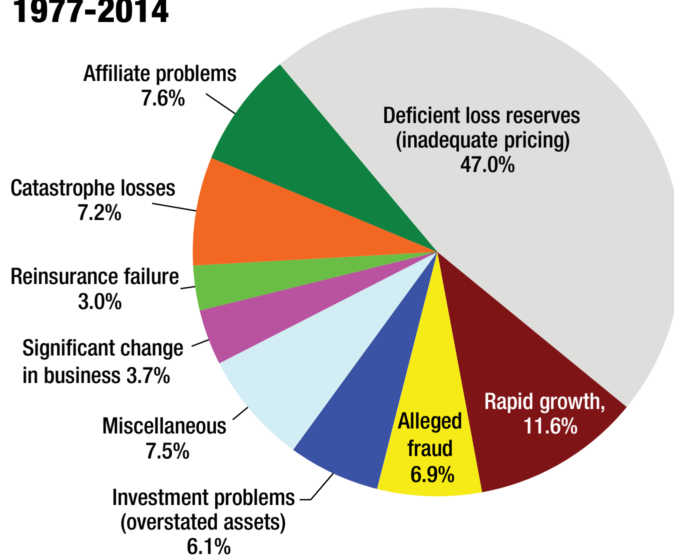
*Domestic Professional Surplus Lines
Source: A.M. Best data and research

accounted for 38.0% of surplus lines impairments and 58.6% of admitted P/C company impairments.

The second-highest cause of surplus lines impairments has been affiliate problems at 20%, vs. 7.6% for admitted P/C companies. Some surplus lines companies became impaired when their parent companies, which were engaged primarily in the admitted market, were declared insolvent. Some of these past instances of surplus lines failures highlight the extent to which poorly managed operations of a parent company can impact its surplus lines affiliates.

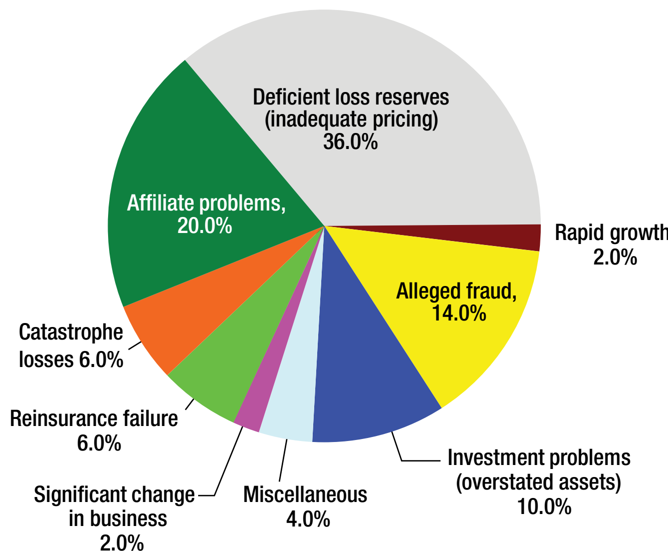
Alleged fraud was the next highest cause of impairment among surplus lines companies at 14.0% vs. 6.9% for admitted companies. All other causes of impairment for surplus lines and admitted insurers accounted for 28% and 26.9%, respectively, of the identified impediments. A.M. Best believes that except for those insolvencies directly related to catastrophe losses, all insolvencies are related to some form of mismanagement. In many instances, companies that become impaired because of catastrophe losses tend to be those concentrated in a particular line of business or geographic area, and have been financially weakened by years of operating losses.

Exhibit 24
U.S. Property/Casualty Admitted – Primary Causes of Financial Impairment, 1977-2014



Note: Exhibit % based on companies where the cause of impairment was identified.
Source: A.M. Best data and research

Exhibit 25
U.S. Surplus Lines – Primary Causes of Financial Impairment, 1977-2014



Note: Exhibit % based on companies where the cause of impairment was identified.
Source: A.M. Best data and research

Looking at impairments by line of business, the "other liability" category – encompassing directors and officers (D&O), errors and omissions (E&O), general liability, contractual liability, and excess umbrella – accounted for the highest percentage of surplus lines impairments over the course of time that A.M. Best has studied P/C impairment trends. The workers' compensation and commercial automobile lines caused the second and third highest number of impairments, respectively. Workers' compensation is not a major line of coverage for surplus lines insurers but a surplus lines insurer's impairment could result

from adverse workers' compensation experience of one or more admitted insurers within the same group of companies.

Conclusion

Over the span of time that A.M. Best has studied financial impairments, a strong correlation has been found between the insurance industry's financial impairment frequency and negative operating environments marked by events such as high catastrophe losses; severe downturns in the stock market; or economic recessions. Most often, the triggers for a marked increase in impairments have been sudden, major events that pushed companies already made vulnerable by negative operating performance or mismanagement beyond the brink, and into financial impairment.

Financially Impaired Companies Defined

A.M. Best designates an insurer as a Financially Impaired Company (FIC) as of the first official regulatory action taken by an insurance department, whereby the insurer's:

- Ability to conduct normal insurance operations is adversely affected;
- Capital and surplus have been deemed inadequate to meet legal requirements; and/or
- General financial condition has triggered regulatory concern.

State actions include supervision, rehabilitation, liquidation, receivership, conservatorship, cease-and-desist orders, suspension, license revocation and certain administrative orders. A.M. Best emphasizes that the FICs in this study might not technically have been declared insolvent.Note that the above definition of an FIC is broader than that of a Best's Rating of "E" (under regulatory supervision), which is assigned only when an insurer is "no longer allowed to conduct normal ongoing insurance operations." Thus, a company may be designated as financially impaired in this study but may not have been assigned an "E" Best's Rating. Further, a Best's Rating of "F" (in liquidation) can reflect aliquidation as part of the impairment process, or it can indicate a voluntary dissolution. Unless they occur under financial duress, voluntary dissolutions are not counted as impairments. Before 1992, a Best's Rating of "NA-10" was used to indicate that a company was under regulatory supervision and/or in liquidation.

Revisions

As a result of ongoing research efforts, A.M. Best's impairment database is updated continually to reflect the incorporation of new data or adjustments to existing data. The most common revision to the data is a company's initial year of impairment. If any change places a company outside of this study's parameters, the company is eliminated from the study.

Confidential Supervisions

In addition to the regulatory actions that are announced publicly, there also are actions that insurance regulators undertake on a confidential basis. When A.M. Best becomes aware of an active confidential regulatory action, the impairment is counted in the aggregate analysis, but is not reported on a company-specific basis to protect confidentiality. While the reporting of confidential actions likely is understated, A.M. Best believes a full accounting of these nonpublic actions would not change materially its impairment analysis.

Section VI – Fundamentals of The Surplus Lines Market

The U.S. surplus lines market (also called the nonadmitted market) functions as a supplemental market for insuring risks that are not acceptable to the standard insurance market (also called the admitted market).

The insurers in the surplus lines market are property/casualty companies that distribute their products to consumers through surplus lines producers. Consumers that are unable to secure insurance coverage from standard (admitted) insurers also have the option of self-insuring or seeking coverage in the alternative risk transfer (ART) market.

The risks insured in the surplus lines market are usually classified as one of the following:

- **Distressed risks** – characterized by unfavorable attributes, such as a history of frequent losses or the potential for catastrophic losses that make them unacceptable to admitted insurers. Examples of distressed risks include a vacant building located in an area that experiences frequent crime losses, a shopping mall with frequent liability claims or a manufacturer of explosives.
- **Unique risks** – so specialized or unusual that admitted insurers are unwilling or unprepared to insure them. An example of a unique risk is a medical device manufacturer that needs product liability coverage while a new product is in clinical trials.
- **High-capacity risks** – requiring high insurance limits that may exceed the capacity of the standard market. An example of a high-capacity risk is a chemical plant that could become legally liable for hundreds of millions of dollars in damages if a toxic chemical were to escape in large quantities.
- **New or emerging risks** – requiring special underwriting expertise and flexibility that the surplus lines market can provide. Examples of new or emerging risks that are in need of property and/or liability coverage include the nonmilitary use of unmanned aircraft systems (drones) and marijuana businesses in states that have legalized the medical or recreational use of marijuana.

The surplus lines market has historically been an innovator of new kinds of insurance coverage designed to meet emerging market needs. Examples of policies that were originated by surplus lines carriers include cyber risk, environmental impairment liability, employment practices liability, directors and officers liability, and excess and umbrella liability. These types of policies can now be obtained in either the standard (admitted) insurance market or the surplus lines market, depending on the characteristics of the particular risk.

The majority of surplus lines business consists of commercial lines insurance, although some personal lines coverage, such as homeowners insurance in catastrophe-prone areas, is also written on a nonadmitted basis..

Surplus lines insurers are referred to as nonadmitted insurers because they are not licensed (admitted) in the state where the insured's principal place of business is located or where the insured resides. This state is known as "the insured's home state" and is the state that is responsible by federal law for oversight and regulation of the surplus lines transaction. Every U.S. jurisdiction has a surplus lines law that permits specially licensed intermediaries (surplus lines brokers/licensees) to "export" risks that cannot be placed in the standard market to eligible surplus lines (nonadmitted) insurers.

Although not a licensed insurer in the "home state of the insured," each surplus lines insurer is licensed in its state or country of domicile and is regulated for solvency by that jurisdiction. This is the same approach used by the state-based insurance regulatory system in the United States to assure the

financial stability of licensed or admitted insurers. As a nonadmitted carrier, a surplus lines insurer is not subject to the rate and form regulations of the insured's home state and is therefore free to use policy forms and rates that are appropriate for the risks it accepts. State regulation of licensed or admitted insurers, in contrast, includes the oversight of insurance policy rates and forms. The purpose of this special regulatory approach to surplus lines insurers is to ensure that the surplus lines market provides an open and flexible marketplace for insureds that are unable to fulfill their insurance requirements in the state's admitted or standard market.

When the insurance market or capacity becomes restricted and market conditions "harden," standard market carriers typically reduce their appetites for some risks or lines of insurance, and business flows into the surplus lines market. Even under normal market conditions or when the market is considered "soft," there are still many distressed, unique, high-capacity and new or emerging risks that require surplus lines treatment. In fulfilling the role of insuring risks that the admitted market cannot or will not insure, the surplus lines market operates as a "safety valve" for the insurance marketplace.

The minimum capitalization requirement for surplus lines insurers is generally higher in each state than it is for admitted insurers. This enhanced capital standard provides greater protection for policyholders insured by surplus lines companies, since state guaranty fund protection, provided to policyholders of admitted insurers that become insolvent, is not generally available to surplus lines insureds. (See Section II for current financial trends in the surplus lines market).

Market Cycles

In general, the condition of the admitted insurance market affects the state of the surplus lines market. (See Section I for the latest surplus lines market trends). This impact, on occasion, can be significant. When admitted market conditions harden or become more difficult, a sizable amount of business flows from the admitted market to the surplus lines market. During a hard market, underwriters tend to become more conservative and restrictive, examining loss exposures more carefully to determine how a particular risk under consideration can be written at a profit.

In these circumstances, standard market carriers only insure those risks that they are most comfortable in assuming and tend to avoid risks that are more complex or with which they have little or no experience.

As the market cycle progresses, competition heats up and market conditions in the admitted market "soften" as producers and insurers strive to maintain market share by reducing rates, expanding coverage and offering additional services at the expense of profit margins. During this soft market phase of the cycle, consumers' bargaining power increases significantly, causing rates to drop and coverage limitations or exclusions to be relaxed. When these circumstances occur, business begins to return to the admitted market.

Over time, competitive pricing pressures erode admitted market capacity as margins deteriorate to unprofitable levels. This again leads to a hardening of the market, and the cycle continues.

Industry Participants

For the purposes of this report, A.M. Best has categorized surplus lines insurers into three broad segments:

- Domestic professional companies: This largest segment is represented by U.S.-domiciled insurers that write 50% or more of their total premium on a nonadmitted basis.
- Domestic specialty companies: U.S.-domiciled insurers that operate to some extent on a nonadmitted basis but whose direct nonadmitted premium writings amount to less than 50% of their total direct premiums written.

- Regulated aliens (including Lloyd's): To qualify as a regulated alien, insurers must file financial statements, copies of auditors' reports, the names of their U.S. attorneys or other representatives and details of their U.S. trust accounts with the International Insurers Department (IID) of the National Association of Insurance Commissioners (NAIC). Additionally, regulated aliens must fulfill criteria established by the IID concerning capital and/or surplus, reputation of financial integrity, and underwriting and claims practices. On a quarterly basis, the NAIC publishes its Quarterly Listing of Alien Insurers, which lists alien insurers that meet its criteria.

As a result of the Nonadmitted and Reinsurance Reform Act (NRRA) of 2010, which was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a state may not prohibit a surplus lines broker from placing nonadmitted (surplus lines) insurance with or procuring such insurance from a nonadmitted insurer listed on the NAIC Quarterly Listing of Alien Insurers.

Distribution

Retail producers, surplus lines intermediaries and program managers are the primary distributors for surplus lines insurers. All of these entities play an important role in helping consumers find insurance coverage that is unavailable in the standard market. (See Section IV for a description of current surplus lines distribution issues).

For purposes of this special report, the types of organizations within the surplus lines distribution system are defined as follows:

- Retail producers can be either agents that represent the insurer or brokers that represent the insured.
- Surplus lines intermediaries can operate as wholesale brokers, managing general agents (MGAs), underwriting managers or Lloyd's coverholders or open market correspondents (OMCs).
- Program managers are managers of specialty or niche insurance products and market to retailers, wholesalers or both.

Surplus lines intermediaries are licensed in the states where the insured or risk is located and act as intermediaries between retail producers and surplus lines insurers. Typically, a surplus lines intermediary provides the retail producer and the insured with access to the surplus lines market when the admitted market cannot provide coverage or the risk otherwise qualifies for export.

The basic difference between wholesale brokers and MGAs is that MGAs are authorized to underwrite and bind coverage on behalf of the surplus lines insurer through binding authority agreements. Wholesale brokers only have the authority to submit business to surplus lines insurers. The insurers then underwrite, quote and, if the risk is considered to be acceptable, bind the risk. In addition, some MGAs have claims-handling responsibilities and may be involved in the placement of reinsurance.

Lloyd's coverholders are authorized to bind coverage on behalf of underwriting syndicates at Lloyd's. OMCs are approved for placing coverage at Lloyd's either directly or through a Lloyd's broker.

Surplus lines laws generally require that a "diligent search" of the admitted market be performed before a risk can be exported to a surplus lines insurer. In general, the diligent-search requirement, which assures the admitted market the first opportunity to insure the risk, requires that three declinations from admitted insurers be obtained before the risk can be placed in the surplus lines market.

In certain states, specified types of risks can be placed in the surplus lines market without the diligent search requirement being fulfilled. Many states have created an "export list," which sets forth types of risks for which the insurance commissioner has determined there is little or no

coverage available in the state's admitted market. A type of risk that appears on the export list can be exported, without a diligent search, to an eligible surplus lines insurer. Also, a few states have commercial lines deregulation laws that allow for "automatic export" waivers, giving qualifying commercial buyers and their brokers or intermediaries immediate access to the surplus lines market, as well as access to a deregulated admitted market, without a diligent search.

In a surplus lines transaction, the surplus lines intermediary is generally responsible for:

- Filing an affidavit affirming that a diligent search has been performed, when it is required;
- Maintaining the records relating to the transaction; and
- Collecting premium taxes and remitting them to the insured's home state.

In addition to facilitating the surplus lines placement, the surplus lines intermediary provides a number of services, which include:

- Technical expertise about the risk to be insured;
- Extensive insurance product and market knowledge;
- Ability to respond quickly to changing market conditions; and
- Access to eligible surplus lines insurers.

Licensing and Compliance

In a surplus lines transaction, the insured's home state exercises the greatest degree of regulatory oversight, and the onus of regulatory compliance is placed on the surplus lines broker or licensee, which is the regulated entity in the transaction.

In addition to being a licensed (resident or nonresident) agent or broker, a surplus lines broker or licensee must do the following:

- In many states, pass a written surplus lines licensing examination to secure a resident license;
- Collect the state's surplus lines premium taxes;
- Pay an annual licensing fee; and
- Determine whether the risk meets all the requirements for placement with a surplus lines insurer.

Further, the surplus lines broker or licensee is responsible for determining whether the nonadmitted insurer insuring the risk meets the insured's home state eligibility requirements. A broker or licensee may be held liable for payment of claims when a risk is placed with a surplus lines insurer not authorized to receive the risk, or with one that is financially unsound when the risk is bound. However, depending on state law, there may be no cause of action against a broker, under a negligence standard, who exercises due diligence or care in selecting the insurer, even if the insurer becomes insolvent years later.

Surplus lines policies must disclose that a nonadmitted insurer is providing coverage and that guaranty fund protection will not be available if the insurer becomes insolvent.

Conclusion

This section on "Fundamentals" is a primer for readers who are not already familiar with the surplus lines market, to assist them in understanding this unique insurance marketplace and to put the other sections of this report into context. The fundamentals of the surplus lines market include the participants and their roles, the types of risks insured, the regulatory structure and the responsibilities imposed on the surplus lines broker/licensee and the dynamic role of market cycles.

Appendix A

U.S. Surplus Lines - Top 50 Groups, 2014

Ranked by direct premims written
(USD Thousands)

Rank	A.M. Best #	Group Name	Type of Company	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Best's Financial Strength Rating*	Financial Strength Rating Outlook / Implications	Rating Effective Date
1	085202	Lloyds		$8,157,000	14.9%		A	Positive	22-Jul-15
2	018540	American International Group		$4,679,470	-3.2%	$6,616,409			
2	003535	AIG Specialty Insurance Co	PROF	$899,194		$45,363	A	Stable	27-Feb-15
2	002361	Illinois National Insurance Co	MISC	$63		$36,972	A	Stable	27-Feb-15
2	002350	Lexington Insurance Company	PROF	$3,780,213		$6,534,074	A	Stable	27-Feb-15
3	005987	Nationwide Group		$1,780,987	7.1%	$956,234			
3	001931	Scottsdale Indemnity Company	MISC	$23,141		$37,232	A+	Stable	19-Mar-15
3	003292	Scottsdale Insurance Company	PROF	$1,559,064		$764,852	A+	Stable	19-Mar-15
3	012121	Scottsdale Surplus Lines Ins	PROF	$10,828		$46,666	A+	Stable	19-Mar-15
3	000601	Western Heritage Insurance Co	PROF	$187,954		$107,484	A+	Stable	19-Mar-15
4	018252	W. R. Berkley Insurance Group		$1,485,813	11.9%	$996,022			
4	003026	Admiral Insurance Company	PROF	$443,067		$615,642	A+	Stable	22-Jan-15
4	014158	Berkley Assurance Company	PROF	$42,926		$51,746	A+	Stable	22-Jan-15
4	011296	Berkley Regional Specialty Ins	PROF	$22,204		$52,934	A+	Stable	22-Jan-15
4	012118	Gemini Insurance Company	PROF	$467,658		$54,271	A+	Stable	22-Jan-15
4	011231	Great Divide Insurance Co	MISC	$2,975		$66,909	A+	Stable	22-Jan-15
4	001990	Nautilus Insurance Company	PROF	$506,983		$154,521	A+	Stable	22-Jan-15
5	018549	Zurich Financial Svcs NA Group		$1,204,753	-2.2%	$565,903			
5	002147	Empire Fire & Marine Ins Co	MISC	$285		$44,396	A+	Stable	26-Nov-14
5	002148	Empire Indemnity Ins Co	PROF	$151,349		$50,030	A+	Stable	26-Nov-14
5	003557	Steadfast Insurance Company	PROF	$1,051,685		$436,185	A+	Stable	26-Nov-14
5	003565	Zurich American Ins Co of IL	MISC	$1,433		$35,292	A+	Stable	26-Nov-14
6	018468	Markel Corporation Group		$1,191,418	3.8%	$1,319,262			
6	003677	Alterra Excess & Surplus Ins	PROF	$192,957		$158,321	A	Stable	15-May-15
6	004898	Associated International Ins	PROF	$41,394		$109,075	NR		
6	002732	Essex Insurance Company	PROF	$472,335		$416,532	A	Stable	15-May-15
6	003759	Evanston Insurance Company	PROF	$484,732		$635,334	A	Stable	15-May-15
7	018498	ACE INA Group		$1,032,388	5.7%	$329,338			
7	003510	Illinois Union Insurance Co	PROF	$457,250		$159,550	A++ u	Negative	2-Jul-15
7	004433	Westchester Surplus Lines Ins	PROF	$575,138		$169,787	A++ u	Negative	2-Jul-15
8	018728	Ironshore Insurance Group		$894,986	20.1%	$482,419			
8	013847	Ironshore Indemnity Inc.	MISC	$14,286		$156,603	A u	Negative	31-Jul-15
8	013866	Ironshore Specialty Ins Co	PROF	$880,700		$325,815	A u	Negative	31-Jul-15
9	000811	Berkshire Hathaway Ins Group		$835,316	48.0%	$7,649,707			
9	003806	General Star Indemnity Co	PROF	$156,426		$615,985	A++	Stable	17-Jun-14
9	002540	Mount Vernon Fire Ins Co	PROF	$98,329		$395,241	A++	Stable	12-Jun-15
9	002428	National Fire & Marine Ins Co	PROF	$540,747		$5,604,726	A++	Stable	21-May-14
9	001824	National Indem Co of the South	MISC	$1,280		$177,447	A++	Stable	21-May-14
9	004406	National Indem Co of Mid-Amer	MISC	$1,415		$170,269	A++	Stable	21-May-14
9	003736	U S Underwriters Insurance Co	PROF	$28,975		$122,718	A++	Stable	12-Jun-15
9	002541	United States Liability Ins Co	MISC	$8,144		$563,321	A++	Stable	12-Jun-15
10	003116	Fairfax Financial (USA) Group		$793,974	-5.2%	$525,347			
10	012347	American Safety Indemnity Co	PROF	$9,493		$128,147	NR		
10	011123	Crum & Forster Specialty Ins	PROF	$132,197		$47,313	A	Stable	4-Jun-15
10	011883	First Mercury Insurance Co	PROF	$319,461		$55,862	A	Stable	4-Jun-15
10	014995	Hudson Excess Insurance Co	PROF	$13,192		$58,847	A	Stable	5-May-15
10	012631	Hudson Specialty Ins Co	PROF	$209,371		$186,779	A	Stable	5-May-15
10	012258	Seneca Specialty Ins Co	PROF	$110,260		$48,400	A	Stable	4-Jun-15
11	018640	Alleghany Ins Holdings Group		$780,702	2.1%	$373,242			
11	001960	Capitol Specialty Ins Corp	PROF	$82,733		$53,485	A	Stable	24-Apr-15
11	013859	Covington Specialty Ins Co	PROF	$161,540		$48,515	A+	Stable	24-Apr-15
11	022013	Fair American Select Ins Co	PROF	$3,666		$46,887	A	Positive	24-Apr-15
11	012619	Landmark American Ins Co	PROF	$532,764		$224,355	A+	Stable	24-Apr-15
12	018313	CNA Insurance Companies		$745,886	-7.7%	$241,607			
12	003538	Columbia Casualty Company	PROF	$745,886		$241,607	A	Stable	16-Dec-14
13	018130	XL America Group		$726,916	17.2%	$97,731			

Appendix A

U.S. Surplus Lines - Top 50 Groups, 2014

Ranked by direct premims written

(USD Thousands)

Rank	A.M. Best #	Group Name	Type of Company	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Best's Financial Strength Rating*	Financial Strength Rating Outlook / Implications	Rating Effective Date
13	011340	Indian Harbor Insurance Co	PROF	$726,883		$46,171	A	Stable	1-May-15
13	002424	XL Select Insurance Company	PROF	$33		$51,560	A	Stable	1-May-15
14	018603	AXIS Insurance Group		$591,135	8.0%	$205,938			
14	012515	AXIS Surplus Insurance Company	PROF	$591,135		$205,938	A+	Stable	4-Aug-15
15	000012	Chubb Group of Insurance Cos		$574,425	36.1%	$1,599,066			
15	002713	Chubb Custom Insurance Co	PROF	$526,899		$187,382	A++ u	Negative	2-Jul-15
15	003761	Executive Risk Indemnity Inc	MISC	$549		$1,258,019	A++ u	Negative	2-Jul-15
15	011251	Executive Risk Specialty Ins	PROF	$46,976		$153,664	A++ u	Negative	2-Jul-15
16	018484	Arch Insurance Group		$548,931	0.3%	$292,438			
15	012523	Arch Specialty Insurance Co	PROF	$548,931		$292,438	A+	Stable	21-Aug-15
17	004019	Argo Group		$526,338	5.3%	$371,142			
17	003283	Colony Insurance Company	PROF	$522,240		$319,845	A	Stable	2-Oct-14
17	002619	Colony Specialty Insurance Co	MISC	$4,190		$19,989	A	Stable	2-Oct-14
17	011035	Peleus Insurance Company	PROF	-$93		$31,309	A	Stable	2-Oct-14
18	018713	QBE Americas Group		$522,550	-32.7%	$197,459			
18	012562	QBE Specialty Insurance Co	PROF	$522,550		$197,459	A	Stable	15-Jan-15
19	018591	Allied World Assurance Group		$517,559	10.9%	$361,815			
19	012525	Allied World Asr Co (US) Inc	PROF	$213,588		$139,608	A	Stable	16-Dec-14
19	012526	Allied World National Assur Co	MISC	$61,990		$129,657	A	Stable	16-Dec-14
19	011719	Allied World Surplus Lines Ins	PROF	$241,982		$92,550	A	Stable	16-Dec-14
20	004835	Great American P & C Ins Group		$472,564	20.0%	$243,487			
20	003735	American Empire Surplus Lines	PROF	$149,529		$108,414	A+	Stable	20-Mar-15
20	010937	Great Amer Protection Ins Co	PROF	$301		$26,038	A+	Stable	20-Mar-15
20	003837	Great American E&S Ins Co	PROF	$309,094		$45,955	A+	Stable	20-Mar-15
20	003293	Great American Fidelity Ins Co	PROF	$10,832		$45,981	A+	Stable	20-Mar-15
20	014150	Mid-Continent E&S Ins Co	PROF	$2,807		$17,099	A+	Stable	20-Mar-15
21	018720	Catlin US Pool		$443,724	15.3%	$204,276			
21	010092	Catlin Specialty Insurance Co	PROF	$443,724		$204,276	A	Stable	1-May-15
22	018604	State National Group		$434,505	84.4%	$74,980			
22	013105	United Specialty Insurance Co	PROF	$434,505		$74,980	A	Stable	9-Jun-15
23	018783	Aspen US Insurance Group		$425,002	36.6%	$131,940			
23	012630	Aspen Specialty Insurance Co	PROF	$425,002		$131,940	A	Stable	23-Oct-14
24	018756	Starr International Group		$396,987	30.4%	$97,237			
24	013977	Starr Surplus Lines Ins Co	PROF	$396,987		$97,237	A	Stable	20-Oct-14
25	003262	Swiss Reinsurance Group		$378,134	14.7%	$118,685			
25	010783	First Specialty Ins Corp	PROF	$222,710		$70,136	A+	Stable	6-Nov-14
25	011135	North American Capacity Ins Co	PROF	$155,424		$48,550	A+	Stable	6-Nov-14
26	018723	HCC Insurance Group		$375,470	6.3%	$1,908,061			
26	003286	Houston Casualty Company	PROF	$356,178		$1,891,871	A+	Stable	25-Sep-14
26	012531	HCC Specialty Ins Co	PROF	$19,292		$16,190	A+	Stable	25-Sep-14
27	018674	Travelers Group		$360,946	9.1%	$960,742			
27	004869	Northfield Insurance Co	PROF	$115,829		$126,184	A++	Stable	28-May-15
27	004025	Northland Casualty Company	MISC	$984		$35,409	A++	Stable	28-May-15
27	000712	Northland Insurance Company	MISC	$4,159		$538,940	A++	Stable	28-May-15
27	003592	St. Paul Surplus Lines Ins Co	PROF	$26,486		$194,869	A++	Stable	28-May-15
27	000241	Travelers Excess & Surp Lines	PROF	$213,488		$65,340	A++	Stable	28-May-15
28	000060	Liberty Mutual Insurance Cos		$350,326	-19.4%	$97,565			
28	012078	Liberty Surplus Ins Corp	PROF	$350,326		$97,565	A	Stable	24-Sep-14
29	018081	Navigators Insurance Group		$316,220	24.2%	$1,026,915			
29	001825	Navigators Insurance Company	MISC	$27		$893,946	A	Stable	3-Jun-15
29	010761	Navigators Specialty Ins Co	PROF	$316,194		$132,969	A	Stable	3-Jun-15
30	018523	Assurant P&C Group		$296,295	-3.4%	$220,002			
30	002050	Standard Guaranty Ins Co	MISC	$136,887		$160,733	A	Stable	21-Nov-14
30	002861	Voyager Indemnity Ins Co	PROF	$159,409		$59,270	A	Stable	21-Nov-14
31	018753	Munich-American Hldng Corp Cos		$296,040	6.9%	$242,655			
31	013062	Amer Modern Surpl Lines Ins Co	PROF	$31,834		$26,683	A+	Stable	13-Nov-14

Appendix A
U.S. Surplus Lines - Top 50 Groups, 2014
Ranked by direct premims written
(USD Thousands)

Rank	A.M. Best #	Group Name	Type of Company	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Best's Financial Strength Rating*	Financial Strength Rating Outlook / Implications	Rating Effective Date
31	002666	American Modern Select Ins Co	MISC	$844		$44,879	A+	Stable	13-Nov-14
31	003763	American Western Home Ins Co	PROF	$53,791		$63,228	A+	Stable	13-Nov-14
31	014838	HSB Specialty Insurance Co	PROF	$4,433		$49,794	A++	Stable	6-Feb-15
31	012170	Princeton Excess & Surp Lines	PROF	$205,138		$58,070	A+	Stable	13-Nov-14
32	002946	Western World Insurance Group		$277,071	13.4%	$624,510			
32	002598	Tudor Insurance Company	PROF	$62,313		$172,421	A	Stable	6-Nov-14
32	003132	Western World Insurance Co	PROF	$214,758		$452,089	A	Stable	6-Nov-14
33	018620	Endurance Specialty Group		$268,714	39.8%	$90,259			
33	013033	Endurance American Spec Ins Co	PROF	$268,714		$90,259	A	Stable	28-May-15
34	003883	RLI Group		$259,933	-0.2%	$461,140			
34	002591	Mt Hawley Insurance Company	PROF	$259,933		$461,140	A+	Stable	4-Jun-15
35	018626	James River Group		$252,707	31.3%	$174,119			
35	013985	James River Casualty Company	PROF	$5,971		$15,862	A-	Positive	26-Jun-15
35	012604	James River Insurance Co	PROF	$246,736		$158,257	A-	Positive	26-Jun-15
36	005696	Everest Re U.S. Group		$225,986	27.6%	$78,588			
36	012096	Everest Indemnity Insurance Co	PROF	$225,377		$57,548	A+	Stable	25-Jul-14
36	011197	Everest Security Insurance Co	MISC	$609		$21,040	A+	Stable	25-Jul-14
37	018490	White Mountains Insurance Grp		$225,063	1.5%	$162,199			
37	010604	Homeland Ins Co of NY	PROF	$200,571		$111,328	A	Stable	3-Oct-14
37	014398	Homeland Insurance Company DE	PROF	$24,492		$50,872	A	Stable	3-Oct-14
38	000856	State Auto Insurance Companies		$222,567	24.0%	$99,813			
38	013023	Rockhill Insurance Company	PROF	$222,567		$99,813	A-	Stable	28-Apr-15
39	000897	IFG Companies		$190,370	-16.3%	$455,048			
39	000709	Burlington Insurance Company	PROF	$187,960		$180,745	A	Stable	12-Jun-15
39	012242	Guilford Insurance Company	PROF	$2,410		$274,304	A	Stable	12-Jun-15
40	018717	HIIG Group		$182,997	11.0%	$280,336			
40	013825	Houston Specialty Insurance Co	PROF	$121,821		$263,641	A-	Stable	23-Jan-15
40	014363	Oklahoma Specialty Ins Co	PROF	$61,176		$16,695	A-	Stable	23-Jan-15
41	018669	Global Indemnity Group		$177,300	11.2%	$369,462			
41	003674	Penn-America Insurance Company	PROF	$69,751		$84,418	A	Stable	12-Jun-15
41	011460	Penn-Patriot Insurance Company	PROF	$1,985		$20,615	A	Stable	12-Jun-15
41	012050	Penn-Star Insurance Company	PROF	$44,648		$49,300	A	Stable	12-Jun-15
41	003128	United National Insurance Co	PROF	$58,497		$195,876	A	Stable	12-Jun-15
41	000447	United National Specialty Ins	MISC	$2,418		$19,254	A	Stable	12-Jun-15
42	003873	SCOR U S Group		$174,815	27.8%	$51,676			
42	002837	General Security Indem Co AZ	PROF	$174,815		$51,676	A	Stable	1-Oct-14
43	004294	The Cincinnati Insurance Cos		$162,412	19.1%	$265,556			
43	013843	Cincinnati Specialty Undrs Ins	PROF	$162,412		$265,556	A	Stable	12-Dec-14
44	018733	Philadelphia Ins/Tokio Mar Grp		$161,444	58.6%	$173,937			
44	000763	Tokio Marine Specialty Ins Co	PROF	$161,444		$173,937	A++	Stable	4-Jun-15
45	014027	Kinsale Insurance Company		$157,917	27.2%	$104,101			
45	014027	Kinsale Insurance Company	PROF	$157,917		$104,101	A-	Stable	9-Apr-15
46	018653	Maxum Specialty Insurance Grp		$151,425	5.1%	$109,724			
46	012563	Maxum Indemnity Company	PROF	$151,425		$109,724	A-	Negative	22-May-15
47	018567	IAT Insurance Group		$150,163	5.2%	$286,247			
47	011774	Acceptance Casualty Ins Co	PROF	$7,803		$49,427	A-	Stable	11-Jun-15
47	010611	Acceptance Indemnity Ins Co	PROF	$93,423		$129,182	A-	Stable	11-Jun-15
47	000975	Wilshire Insurance Company	MISC	$48,937		$107,639	A-	Stable	11-Jun-15
48	003926	Selective Insurance Group		$147,070	14.0%	$66,794			
48	013842	Mesa Underwriters Spec Ins Co	PROF	$147,070		$66,794	A	Stable	28-May-15
49	025045	GeoVera U.S. Insurance Group		$141,024	-4.9%	$22,359			
48	011678	GeoVera Specialty Insurance Co	PROF	$141,024		$22,359	A	Stable	5-Jun-15
50	018587	Atain Insurance Companies		$110,008	25.8%	$199,155			
50	012422	Atain Insurance Company	PROF	$4,857		$45,743	A	Stable	12-Jun-15
50	002842	Atain Specialty Insurance Co.	PROF	$105,152		$153,412	A	Stable	12-Jun-15

* Ratings are as of August 21, 2015
Source: A.M. Best data and research

Appendix B

U.S. Domestic Professional Surplus Lines – Entrances & Exits, 2010-2014

X denotes domestic professional surplus companies, defined as companies with direct premium from surplus lines business greater than 50% of total premium.

Company Name	2010	2011	2012	2013	2014
Acceptance Casualty Insurance Co			X	X	X
Acceptance Indemnity Insurance Co	X	X	X	X	X
Admiral Insurance Co	X	X	X	X	X
Adriatic Insurance Co	X	X	X	X	X
AIG Specialty Insurance Co	X	X	X	X	X
AIX Specialty Insurance Co	X	X	X	X	X
Allianz Underwriters Insurance Co	X	X	X	X	X
Allied World Asr Co (US) Inc			X	X	X
Allied World Surplus Lines Ins	X	X	X	X	X
Alterra Excess & Surplus Ins	X	X	X	X	X
American Empire Surplus Lines	X		X	X	X
American Modern Surpl Lines Ins Co	X	X	X	X	X
American Mutual Share Ins Corp	X	X	X	X	X
American Safety Indemnity Co	X	X	X	X	X
American Safety Insurance Co	X	X	X	X	X
American Western Home Ins Co	X	X	X	X	X
Appalachian Insurance Co	X	X	X	X	X
Arch Excess & Surplus Co	X	X			
Arch Specialty Insurance Co	X	X	X	X	X
Aspen Specialty Insurance Co	X	X	X	X	X
Associated Industries Insurance Co			X	X	
Associated International Ins	X	X	X	X	X
Atain Insurance Co	X	X	X	X	X
Atain Specialty Insurance Co.	X	X	X	X	X
Atlantic Casualty Insurance Co	X	X	X	X	X
AXIS Specialty Insurance Co	X				
AXIS Surplus Insurance Co	X	X	X	X	X
Berkley Assurance Co		X	X	X	X
Berkley Regional Specialty Ins	X	X	X	X	X
Burlington Insurance Co	X	X	X	X	X
Canal Indemnity Co	X	X	X	X	X
Canopius US Insurance, Inc.			X	X	X
Capitol Specialty Insurance Corp	X	X	X	X	X
Catlin Specialty Insurance Co	X	X	X	X	X
Century Surety Co	X	X	X	X	X
Chubb Custom Insurance Co	X	X	X	X	
CIM Insurance Corporation	X	X	X	X	
Cincinnati Specialty Undrs Ins	X	X	X	X	X
Clarendon America Insurance Co	X	X			
Colony Insurance Co	X	X	X	X	X
Columbia Casualty Co	X	X	X	X	X
Companion Specialty Ins Co	X	X	X	X	
Covington Specialty Ins Co	X	X	X	X	X
Crum & Forster Specialty Ins	X	X	X	X	X
CUMIS Specialty Ins Co Inc	X	X	X	X	X
Discover Specialty Insurance Co	X	X	X	X	
Empire Indemnity Insurance Co	X	X	X	X	X
Endurance American Spec Ins Co	X	X	X	X	X
Essex Insurance Co	X	X	X	X	X
Evanston Insurance Co	X	X	X	X	X
Everest Indemnity Insurance Co	X	X	X	X	X
Executive Risk Specialty Insurance	X	X	X	X	X
Fair American Select Ins Co					X
Fireman's Fund Ins Co of OH	X	X	X	X	X
First Financial Insurance Co	X	X	X	X	

Company Name	2010	2011	2012	2013	2014
First Mercury Insurance Co	X	X	X	X	X
First Specialty Insurance Corp	X	X	X	X	X
Gemini Insurance Co	X	X	X	X	X
General Security Indem Co AZ	X	X	X	X	X
General Star Indemnity Co	X	X	X	X	X
Genesis Indemnity Insurance Co	X				
GeoVera Specialty Insurance Co	X	X	X	X	X
GNY Custom Insurance Co	X	X	X	X	X
Gotham Insurance Co	X	X	X	X	X
Great Amer Protection Insurance Co			X	X	X
Great American E&S Insurance Co	X	X	X	X	X
Great American Fidelity Insurance Co	X	X	X	X	X
GuideOneNational Insurance Co				X	X
Guilford Insurance Co	X	X	X	X	X
Gulf Underwriters Insurance Co	X		X		
Hallmark Specialty Insurance Co	X	X	X	X	X
HCC Specialty Insurance Co	X	X	X	X	X
Hermitage Insurance Co			X		
Homeland Insurance Co of NY	X	X	X	X	X
Homeland Insurance Company DE				X	X
Houston Casualty Co	X	X	X	X	X
Houston Specialty Insurance Co	X	X	X	X	X
HSB Specialty insurance Co				X	X
Hudson Excess Insurance Co				X	X
Hudson Specialty Insurance Co	X	X	X	X	X
Illinois Union Insurance Co	X	X	X	X	X
Indian Harbor Insurance Co	X	X	X	X	X
Interstate Fire & Casualty Co	X	X	X	X	X
Ironshore Specialty Insurance Co	X	X	X	X	X
James River Casualty Co	X	X	X	X	X
James River Insurance Co	X	X	X	X	X
Kinsale Insurance Co	X	X	X	X	X
Knight Specialty Insurance Co					X
Landmark American Ins Co	X	X	X	X	X
Landmark Insurance Co	X	X			
Lexington Insurance Co	X	X	X	X	X
Liberty Surplus Ins Corp	X	X	X	X	X
Maiden Specialty Insurance Co	X	X	X	X	X
Maxum Indemnity Co	X	X	X	X	X
Medical Security Insurance Co				X	X
Merchants National Ins Co	X	X	X	X	X
Mesa Underwriters Spec Ins Co			X	X	X
Mid-Continent Excess & Surplus			X	X	X
Montpelier US Insurance Co	X				
MSA Insurance Co	X	X	X	X	X
MSI Preferred Insurance Co	X	X	X		
Mt Hawley Insurance Co	X	X	X	X	X
Mt Vernon Fire Insurance Co	X	X	X	X	X
NAMIC Insurance Co, Inc	X	X	X	X	X
National Fire & Marine Ins Co	X	X	X	X	X
National Guaranty Ins Co of Vermont	X	X	X	X	X
Nautilus Insurance Co	X	X	X	X	X
Navigators Specialty Ins Co	X	X	X	X	X
Nevada Capital Insurance Co				X	
Newport Insurance Co			X		

Apendix B

U.S. Domestic Professional Surplus Lines – Entrances & Exits, 2010-2014

X denotes domestic professional surplus companies, defined as companies with direct premium from surplus lines business greater than 50% of total premium.

Company Name	2010	2011	2012	2013	2014
Noetic Specialty Insurance Co	X	X		X	X
North American Capacity Ins Co	X	X	X	X	X
North Light Specialty Insurance Co	X	X	X	X	X
Northfield Insurance co				X	X
Nutmeg Insurance Co	X	X			X
Oklahoma Specialty Ins Co				X	X
Old Guard Insurance Co	X	X	X		
Old Republic Union Ins Co	X	X	X	X	X
Omega US Insurance Inc	X	X			
Pacific Insurance Co, Ltd	X	X	X	X	X
Peleus Insurance Company	X	X	X	X	X
Penn-America Insurance Co	X	X	X	X	X
Penn-Patriot Insurance Co	X	X	X	X	X
Penn-Star Insurance Co	X	X	X	X	X
Philadelphia Insurance Co	X	X			
Prime Insurance Co	X	X	X	X	X
Prime Insurance Syndicate Inc					
Princeton Excess & Surp Lines	X	X	X	X	X
ProAssurance Specialty Ins Co	X	X	X	X	X
Professional Security Ins Co	X			X	X
Professional Underwriters Liability	X	X	X		
Protective Specialty Ins Co		X	X	X	X
QBE Specialty Insurance Co	X	X	X	X	X
Rainier Insurance Co					
Republic-Vanguard Ins Co	X	X	X	X	X
Rockhill Insurance Co	X	X	X	X	X
SAFECO Surplus Lines Insurance Co	X	X			
Sagamore Insurance Co		X	X		
Savers Property & Casualty Ins Co			X		
Scottsdale Insurance Co	X	X	X	X	X

Company Name	2010	2011	2012	2013	2014
Scottsdale Surplus Lines Ins	X	X	X	X	X
Seneca Specialty Ins Co	X	X	X	X	X
Southwest Marine & General	X	X	X	X	X
SPARTA Specialty Insurance Co			X	X	X
Specialty Surplus Insurance Co	X				
St. Paul Fire & Casualty Ins	X	X	X	X	
St. Paul Surplus Lines Ins Co	X	X	X	X	X
Standard Guaranty Ins Co	X	X	X		
Starr Surplus Lines Ins Co	X	X	X	X	X
Steadfast Insurance Co	X	X	X	X	X
TDC Specialty Insurance Co				X	X
TM Specialty Insurance Co	X	X	X		
Tokio Marine Specialty Ins Co			X	X	X
Torus Specialty Insurance Co	X	X	X	X	X
Traders & General Ins Co	X	X	X		
Travelers Excess & Surp Lines	X	X	X	X	X
TrustStar Insurance Co			X		
Tudor Insurance Co	X	X	X	X	X
United National Insurance Co	X	X	X	X	X
United Specialty Insurance Co	X	X	X	X	X
US Underwriters Insurance Co	X	X	X	X	X
Utica Specialty Risk Ins Co	X	X	X	X	
Valiant Specialty Insurance Co	X	X	X		
Voyager Indemnity Ins Co	X	X	X	X	X
Westchester Surplus Lines Ins	X	X	X	X	X
Western Heritage Insurance Co	X	X	X	X	X
Western World Insurance Co	X	X	X	X	X
Wilshire Insurance Co			X		
XL Select Insurance Co	X	X	X	X	X

Source: A.M. Best data and research

Appendix C
U.S. State Survey: Regulated & Unregulated Alien Lists

State	Regulated Alien List Maintained	Unregulated Alien List Maintained	Alien Insolvencies Tracked	Fraud Unit
Alabama^	No	No	No	Yes
Alaska^	Yes**	No	No	Yes
Arizona^	No**	No	No	No
Arkansas	Yes**	No	No	Yes
California	Yes****	No	No	Yes
Colorado^	Yes	No	No	Yes
Connecticut	No	No	No	Yes
Delaware	Yes**	No	No	No
Dist of Columbia	No	No	No	No
Florida	Yes (1)	Yes (2)	No (3)	Yes (4)
Georgia	Yes**	No	No	Yes
Hawaii^	Yes**	No	No	No
Idaho	Yes*	No	Yes	Yes
Illinois	No	Yes	No	Yes
Indiana	Yes*	No	No	No
Iowa^	Yes*	No	No	No
Kansas^	Yes*	No	No	Yes
Kentucky	Yes*	No	No	Yes
Louisiana^	Yes	No	No	Yes
Maine	Yes	No	No	No
Maryland^	Yes*	No	No	No
Massachusetts	Yes**	No	No	Yes
Michigan (5)	Yes	No	No	No
Minnesota	Yes	No	No	Yes
Mississippi^	Yes**	No	No	Yes
Missouri	Yes*	No	No	Yes

State	Regulated Alien List Maintained	Unregulated Alien List Maintained	Alien Insolvencies Tracked	Fraud Unit
Montana^	No	Yes	No	Yes
Nebraska^	No	No	No	Yes
Nevada	Yes**	No	No	Yes
New Hampshire	Yes**	No	No	No
New Jersey^	No	No	No	No
New Mexico	Yes*	No	No	No
New York^	No	No	Yes	Yes
North Carolina^	Yes (6)	No (6)	No	Yes
North Dakota	Yes**	No	No	Yes
Ohio^	Yes**	Yes	No	No
Oklahoma^	Yes	No	No	No
Oregon	No	No	No	No
Pennsylvania	No***	No	Yes	Yes
Puerto Rico^	Yes	No	No	No
Rhode Island	Yes**	No	No	No
South Carolina	No	No	No	No
South Dakota	No	No	No	Yes
Tennessee	No	No	No	No
Texas	Yes**	No	No	Yes
Utah	Yes**	No	Yes	Yes
Vermont	No	No	No	No
Virginia^	No	No	No	No
Washington	No	No	No	Yes
West Virginia	Yes*	No	No	Yes
Wisconsin	No	No	No	No
Wyoming^	Yes**	No	No	No

^ Indicates state's response is as of August 2014. These states have not responded as of August 20, 2015.
* Uses the "white list" from the International Insurers Department of the National Association of Insurance Commissioners.
Source: A.M. Best Co., as of August 20, 2015.
** Uses the "Quarterly Listing of Alien Insurers" from the International Insurers Department of the NAIC to qualify aliens for the ADOI "List of Qualified Unauthorized Surplus Lines Insurers."
*** The Pennsylvania Insurance department maintains a listing of all eligible surplus lines insurers including alien insurers.
**** Uses the "Quarterly Listing of Alien Insurers" from the International Insurers Department of the NAIC
(1) The Florida Office of Insurance Regulation maintains a current listing of all surplus lines insurers including aliens.
(2) The Florida Office of Insurance regulation maintains a list of Federally Authorized Insurers that claim federal exemption (IID list)
(3) An alien insurer insolvency is not tracked once it has become insolvent or disappeared.
(4) There is a unit for unlicensed/unapproved entities that is operated out of the Market Conduct section of the Florida Office of Insurance Regulation. There is no routine monitoring of unregulated alien insurers.
(5) The Michigan Office of Financial and Insurance regulation maintains a current listing of all eligible unauthorized surplus lines including aliens.
(6) The North Carolina Department of Insurance maintains a current listing of all surplus lines carriers that have applied and been approved for regulation, including aliens.

Appendix D

State Survey: Capital & Surplus Requirements for Surplus Lines Companies

State	Domestic Company Minimum Surplus	Alien Company Minimum Surplus	Pending Revisions
Alabama^	$5,000,000	$2,500,000 (1) & $15,000,000	No
Alaska^	$15,000,000	$15,000,000 & 2,500,000 (1)	No
Arizona^	$15,000,000	$15,000,000(8)/ $5,400,000 (1)	No
Arkansas	$20,000,000	N/A	No
California	45,000,000 (2)	(8)	No
Colorado^	$15,000,000	$5,400,000	No
Connecticut	$15,000,000	$15,000,000 (10)	No
Delaware	$15,000,000	$15,000,000	No
Dist of Columbia	$300,000	$300,000	No
Florida	$15,000,000	$15,000,000 (3)	No
Georgia	$4,500,000	$10,000,000 / $10,000,000(1)	No
Hawaii^	$15,000,000	$5,400,000 (1)	No
Idaho	$2,000,000	$15,000,000	No
Illinois	$15,000,000	$15,000,000	No
Indiana	$15,000,000	$15,000,000	No
Iowa^	$15,000,000	N/A	
Kansas^	$4,500,000	$50,000,000	No
Kentucky	$6,000,000	$5,400,000 (3)	No
Louisiana^	$15,000,000	$15,000,000 (8)	No
Maine	$4,500,000	Listed with NAIC International Insurers Department (9)	No
Maryland^	$15,000,000	N/A	No
Massachusetts	$20,000,000	$20,000,000	Yes
Michigan	$7,500,000	$15,000,000 (10)	Yes
Minnesota	$15,000,000	$15,000,000	No
Mississippi^	$1,500,000	$15000000 & 5,400,000 (3)	No
Missouri	$15,000,000	$15,000,000	Yes
Montana^	$15,000,000	$15,000,000	Yes
Nebraska^	$15,000,000	(8)	No
Nevada	$15,000,000	$5,400,000 / 100,000,000 (4)	Yes
New Hampshire	$15,000,000	N/A	No
New Jersey^	$15,000,000	$15,000,000 (6)	N/A
New Mexico	15,000,000 (5)	$15,000,000 (5)	N/A
New York^	$45,000,000	$45,000,000 (9)	No
North Carolina^	$15,000,000	$15,000,000 (11)	No
North Dakota	$15,000,000	$15,000,000	No
Ohio^	$5,000,000	$15,000,000	No
Oklahoma^	$15,000,000	$15,000,000	No
Oregon	$5,000,000	15,000,000 / $5,400,000 (3)	No (6)
Pennsylvania	$15,000,000/ $4,500,000	(8)	No
Puerto Rico^	$300,000 / $1,000,000	$300,000 / $1,000,000	No
Rhode Island	$15,000,000	$15,000,000	No
South Carolina	$15,000,000	$15,000,000	No
South Dakota	$500,000	$500,000	No
Tennessee	$15,000,000	Listed with NAIC International Insurers Department	No
Texas	$15,000,000	(8)	No
Utah	$2,500,000 (1)	$15,000,000	No
Vermont	$15,000,000	$15,000,000	No
Virginia^	$1,000,000/ $3,000,000	Deemed Approval (7)	No
Washington	$15,000,000	(10)	No
West Virginia	$15,000,000	$15,000,000	No
Wisconsin	N/A	N/A	No
Wyoming	$15,000,000	$15,000,000	No

^ Indicates state's response is as of August 2014. These states have not responded as of August 20, 2015.
(1) Trust Fund
(2) Minimum surplus phase-in period for US-domiciled nonadmitted insurers currently on the California list of eligible surplus lines insurers that did not meet the $45 million minimum capital and surplus requirements as of Jan. 1, 2011; the insurer must have capital and surplus if $45 million by December 31, 2013.
(3) In addition, alien carriers required to maintain $5.4 million trust fund in the United States.
(4) Lloyd's
(5) Due to Dodd-Frank
(6) This law became effective January 1, 2012.
(7) Insurers appearing on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC deemed approved in Virginia.
(8) Alien company must be listed on the Quarterly Listing of Alien Insurers maintained by the International Insurance Department of the NAIC.
(9) Due to Dodd-Frank; NAIC Quarterly Listing of Alien Insurers is used for verification purposes. As of January 1, 2013, new alien insurers require $45 million.
(10) Due to Dodd-Frank; NAIC Quarterly Listing of Alien Insurers is used for verification purposes.
(11) For those alien surplus lines carries that have applied and been approved for registration in North Carolina. Additionally, those insurers listed on the NAIC Quarterly Listing of Alien Insurers are deemed eligible in North Carolina.
Source: A.M. Best Co., as of July 17, 2015.

Appendix E
State Survey: Stamping Office & Multi State Taxation

State	Stamping Office	Premium Tax	Stamping Fee	Tax Allocated	Procurement Tax Applies	Procurement Monitored
Alabama^	No	6.00%	No	No	Yes	No
Alaska^	No	2.70%	1.00%	No	Yes	Insured Reports
Arizona^	Yes	3.00%	0.20%	No	No	No
Arkansas	No	4.00%	No	Yes	Yes	Yes
California	Yes	3.00%	0.20%	No	Yes (1)	Yes (1)
Colorado^	No	3.00%	No	Yes	Yes	Yes
Connecticut	No	4.00%	No	No	Yes	Yes
Delaware	No	3.00%	No	No	Yes	Insured Reports
Dist of Columbia	No	2.00%	No	Yes	Yes	No
Florida	Yes	5.00%	0.175%	Yes (3)	Yes	Yes
Georgia	No	4.00%	No	No	Yes	Insured Reports
Hawaii^	No	4.68%	No	Yes	No	No
Idaho	Yes	1.50%	0.25%	No	Yes	Insured Reports
Illinois	Yes	3.50%	0.20%	Yes	No	No
Indiana	No	2.50%	No	No	Yes	Yes
Iowa^	No	1.00%	No	No	Yes	No
Kansas^	No	6.00%	No	No	No	No
Kentucky	No	3.00%	No	Yes	No	Yes
Louisiana^	No	4.85%	No	Yes	Yes	Insured Reports
Maine	No	3.00%	No	No	Yes	Yes
Maryland^	No	3.00%	No	N/A	Yes	Insured Reports
Massachusetts	No	4.00%	No	Yes	No	No
Michigan*	No	2.00%	No	No	No	Yes-Insured Reports
Minnesota	Yes	3.00%	0.06%	No	Yes	Insured Reports
Mississippi^	Yes	4.00%	0.25%	Yes	Yes	Yes
Missouri	No	5.00%	No	No	Yes	Yes
Montana**^	No	2.75%	0.00%	Yes	No	No
Nebraska^	No	3% (9)	No	No (6)	No	No
Nevada	Yes	3.50%	0.40%	No	Yes	Yes
New Hampshire	No	3.00%	No	Yes	Yes	Yes
New Jersey^	No	5.00%	No	No*	Yes (1)	No
New Mexico	No	3.00%	N/A	N/A	No	No
New York^	Yes	3.60%	0.18%	No	Yes	Yes (2)
North Carolina^	No	5.00%	No	No	Yes	Insured Reports
North Dakota	No	1.75%	No	No	Yes	No
Ohio^	No	5.00%	No	No	Yes	No
Oklahoma^	No	6.00%	No	Yes	No	Insured Reports
Oregon	Yes	2.3% (4)	$15.00	No	Yes	No
Pennsylvania	Yes	3.00%	$25.00	No	Yes	Insured Reports
Puerto Rico^	No	9.00%	No	Yes	Yes	Yes
Rhode Island (7)	No	2.00%	No	No	No	No
South Carolina	No	4.00%	No	No	No	No
South Dakota	No	2.5% - 3.0%	No	Yes (8)	Yes	Yes
Tennessee	No	5.00%	No	No	No	No
Texas	Yes	4.85%	0.06%	No	Yes	Insured Reports
Utah	Yes	4.25%	0.25%	Yes	Yes	No
Vermont	No	3.00%	No	N/A	Yes	Yes
Virginia^	No	2.25%	No	No	No	No
Washington	Yes	2.00%	0.10%	No	Yes	Yes

Appendix E
State Survey: Stamping Office & Multi State Taxation

State	Stamping Office	Premium Tax	Stamping Fee	Tax Allocated	Procurement Tax Applies	Procurement Monitored
West Virginia	No	4.55%	No	No	No	No
Wisconsin	No	3.00%	No	No	Yes (5)	No
Wyoming	No	3.00%	No	Yes	Yes	Yes

^ Indicates response is as of August 2014. These states have not responded as of August 20, 2015.
(1) Not by DOI; handled by state franchise tax board.
(2) Not by DOI; handled by Department of Revenue Services/Taxation.
(3) Florida has joined the tax sharing agreement of NIMA. Since 7/1/12, all Florida home state policies get filed at the NIMA Clearinghouse and other NIMA participants will get their portion of the allocated premium. Non-participating state's premium will be retained by the home state.
(4) This amount includes .3% collected for Oregon Fire Marshalls' office.
(5) Tax now 3% on ocean marine business.
(6) Tax payable is the sum of 3% on portion of gross premiums allocated to Nebraska plus other state's applicable tax rates applicable on the portion of the premiums allocated to other states.
(7) Premium taxes are handled by the Division of Taxation.
(8) South Dakota joined the tax sharing agreement of NIMA as of 7/1/12. All of South Dakota's home state policies get filed at the NIMA Clearinghouse and premium is allocated with other participating NIMA states. Non-NIMA states' premium is retained by the home state of the insured.
* In Michigan, a 0.5% regulatory fee applies in addition to the premium tax.
** Assess a 1% stamping fee on paper filings and a 1/2% (0.005) stamping fee on electronically filed policies. No longer necessary for Montana. Effective 1/1/2012, Montana's stamping fee is 0.00% for electronically filed policies and endorsements and paper filings have a 0.25% stamping fee.
Source: A.M. Best Company, as of August 20, 2015.

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Fraud- if you have not considered it, you probably missed it!

By **Lewis Bivona, CPA, AFE**
The INS Companies

Willie Sutton (aka Slick Willie, long before Bill Clinton got the moniker), a famous bank robber and escape artist, was attributed with responding when someone asked him why he robbed so many banks "because that's where all the money is!" Fast forward to 2015, the criminals are thinking in the same vein: why commit healthcare and insurance fraud? That is where billions of dollars are!

Now robbers can do their work from the comfort of home, whether it be in California, Florida, the Ukraine or China. The climate is perfect, claims are electronically generated, received and adjudicated online by insurers and paid via direct wires to a bank account. Attack any link in this process and you are more than likely to hit the gravy train! Guns are no longer needed, a laptop and a proxy server would suit a criminal just fine. Unethical healthcare providers, armed with legitimate information, have skimmed off millions of dollars without being detected by passing off illegitimate claims along with legitimate billings. Juxtapose the 3Rs over the current fraud environment; watch then your fellow examiners' heads explode.

While examiners test systems for intrusion detection and other safeguards, there is no guarantee that these hurdles will be sufficient to prevent fraud. Worse yet, many insurance companies, hospitals and physicians are hurriedly updating legacy systems to deal with healthcare reform mandates, transparency requirements and "friendly user interfaces" with vendors that have outsourced many key coding upgrades to European and third world nation "consultants" to meet critical deadlines. Have these vendors been thoroughly vetted and, even if they were, who is guaranteeing that backdoors have not been built that could be subjectively vulnerable? While we can't solve the worlds fraud issues today, we can focus on questions to ask to determine if the companies we are examining have either fostered conditions conducive to fraud or considered preventive measures to mitigate and reduce the likelihood of fraudulent activities.

Fraud can be cyber, direct or a combination of both. Fraud can impact all the critical risks across the board, so it is our imperative to test the insurer's knowledge of potential risks and determine if they are woven into its ERM processes. The following are some considerations you might care to assess:

Do the Board and management have any idea what potential frauds are emerging in the marketplace?

If they don't, does the Special Investigations Unit (SIU)? For example simple steps to prevent fraud are to assess:

- Are all new providers' credentials verified by a reputable source, such as the state board of medical examiners, the AMA, the AHA, or a key vendor accreditation organization?

- Is the National Practitioner database checked? State regulatory/licensure boards? Paying providers that are on the excluded vendor list can subject the insurer to treble damages for every erroneous dollar paid. You would also be surprised by the number of sanctioned providers that move from state to state staying one step ahead of the law.
- Are the nationalities of providers reviewed? Profiling does seem to bear out that individuals living in certain locations have a greater likelihood of committing fraud (Soviet bloc countries, Dominica, South America, to name a few).
- Are transfers of ownership evaluated? Many fraudsters buy existing businesses that the insurer had previously dealt with, particularly labs, durable medical equipment companies and other ancillary providers. Are controls in place to require notice of transfer of ownership in vendor agreements?

To put a perspective on the impacts of fraud in healthcare, it is useful to reference some interesting statistics compiled by the Coalition Against Insurance Fraud (http://www.insurancefraud.org) that particularly relate to healthcare directly:

- Healthcare expenditures in the U.S. are projected to reach $3.2 trillion in 2015 – or about $10,000 per person. (Centers for Medicare & Medicaid Services, 2015) (See second table, NHE Projections 2014-2024)
- Medicare spending is projected to reach $616.8 billion in FY 2014. (Centers for Medicare & Medicaid Services, 2015)
- Financial losses from healthcare fraud amount to tens of billions of dollars annually. (National Health Care Anti-Fraud Association, 2015)
- Global healthcare fraud and error losses have risen 25 percent to 6.9 percent total since 2008;
- This means $487 billion lost in a year – one-fifth of total U.S. healthcare expenditures for 2011; and
- Reductions in fraud and error losses of up to 40 percent are possible within one year – freeing up to $195 billion globally. (BDO International, March 2014)

Fraud can make a company less competitive than its peers, which generally leads to a continued adverse selection with eventual rehabilitation and/or insolvency actions necessitated by poor operational performance. So what should examiners be looking for at the healthcare company level to ascertain whether they will have a fighting chance of making it to the next financial examination? Some suggested queries of claims and or SIU personnel include:

Fraud- if you have not considered it, you probably missed it!

(continued)

- Simple but often forgotten, what is the general experience level and authorization levels for all personnel involved in the claims function?
- Are data mining efforts performed by knowledgeable individuals that are familiar with audit and data analytical techniques? Hopefully the company has trained accountants and investigators that are knowledgeable in ACL, IDEA or similar software to extract and compare data across a number of platforms (i.e. compare Rx to medical data, are prescriptions supported by an underlying diagnosis?)
- Does the company use underwriting data (acquired prior to ACA) to determine if treatments make sense? Many fraudsters have billed for unnecessary and questionable treatments which could have been detected by comparing medical history documentation to services actually performed.
- Does the company use external data sources to ascertain if its data makes sense? The simplest test is do they compare in-house data to information reported to the Medical Information Bureau (aka MIB). Another would be comparing provider billing and payment locations to that information on the companies credentialing database.
- Are statistical variations analyzed? If an expected rate of magnetic resonance imaging studies is 106 per 1000 insureds in the USA, why is the company running at 150 per 1000? These types of analytics are crucial to ferreting out high cost fraud and over utilization.
- Duplicate claim testing procedures inquiries, how do they perform and what are they doing with the data? Are claims holds automatic with possible duplicates?
- What types of patterns does the company mine for in its data? Pattern mining procedures determine if a particular provider is billing certain billing codes with higher frequency than its peers. An example would be a primary care provider that bills every patient visit as a comprehensive examination when statistically its peers are billing one-third that amount of codes.
- Is the company stratifying data by hospital and by physician specialty? This will reveal aberrant patterns across similar healthcare provider categories
- Are staff actively involved in recurring anti-fraud training? Do they maintain fraud and other professional credentials such as certified public accountant (CPA), member of the Institute of Internal Auditors (IIA) or Association of Certified Fraud Examiners (ACFE)?
- Does the company subscribe to on-line or other sources of fraud information sources?
- Does the company monitor claims and financial accuracy metrics? How do they compare to metrics established by Medicare and Medicaid? Benchmarking performance gives an examiner great insight into how

Fraud- if you have not considered it, you probably missed it!

(continued)

serious the company is about making itself better. Don't forget, many contracts have penalties built in for payor performance which could unveil potential hidden liabilities!

- Often overlooked but very important, how does the company investigate abnormalities reported by its enrollees' reviews of their explanation of benefits?

While all frauds cannot be eliminated, the financial impact of frauds can be mitigated by effective diligence efforts. Many examiners don't feel the necessity to interview claims or SIU personnel under a risk focused examination scenario, but I would submit to you that the best way to determine if potential risks are being mitigated is to ask the right questions of the right personnel closest to the action. Good hunting fellow examiners, may the anti-fraud force be with you!

About the Author

Lewis (Lew) D.Bivona, Jr. CPAm AFE, has over 36 years of experience in the healthcare/insurance industry, 30 of which are in managed care. The depth of his experience has been garnered from high-level positions within the HMO, consulting and hospital industries as well as a period in HMO regulation. He has been with INS-RIS since 2014 as a key member on several statutory examinations and a key member of a market conduct examination team. Prior to joining INS-RIS, Lew was a Partner in Charge of insurance services audit group which audited P&C, L&H, Dental and captives, as well as performing many statutory examinations, pre-licensure due diligence and and rehabilitation/ liquidation engagements

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NAIC Meeting Notes

Global Insurance Industry Group, Americas

NAIC 2015 Summer National Meeting

The National Association of Insurance Commissioners held its Summer National Meeting in Chicago August 15-18. This newsletter contains information on activities that occurred in some of the committees, task forces and working groups that met there, as well as summarizes conference calls before and shortly after the Summer National Meeting. For questions or comments concerning any of the items reported, please feel free to contact us at the address given on the last page.

Executive Summary

- The Executive Committee and Plenary adopted amendments to the PBR Valuation Manual and Actuarial Guideline 49 on life insurance illustrations.
- The Cybersecurity Task Force exposed a draft Cybersecurity Bill of Rights in its continuing work to protect consumers and insurers from cyber-attacks.
- The Financial Condition Committee discussed comments on its June 2015 survey on statutory accounting and the solvency framework.
- The Statutory Accounting Principles Working Group adopted revisions to the XXX/AXXX reinsurance disclosure footnote, exposed for comment three revised proposals relating to SSAP 97 investments, and continued discussion of its investment classification project. The working group also exposed Issue Paper 151, *Valuation for Holders of Surplus Notes*, for comment.
- The PBR Implementation Task Force continues to closely monitor states' adoption of PBR and exposed a proposal for assessing whether a state's PBR law is "substantially similar" to the Standard Valuation Law. The task force also discussed a 2016 PBR Pilot project.
- The Life RBC Working Group finalized its three AG 48 RBC proposals and also adopted its derivatives collateral RBC proposal.
- The Investment RBC Working Group exposed the AAA's highly anticipated report on the construction and development of its proposed life RBC factors for corporate bonds, as well as the ACLI's revised proposal for real estate investments. The working group also began discussion of implementation of revised factors.
- The Operational Risk Subgroup adopted the 2015 operational risk proposal which includes factors for growth risk charges and basic operational risk.
- The Property/Casualty RBC Working Group adopted its 2015 underwriting risk factors and referred to the Capital Adequacy Task Force issues related to affiliated investment risk that would affect all four RBC formulas.
- The Catastrophe Risk Subgroup adopted proposals relating to catastrophe risk charge exemptions and catastrophe factors for PR018A.
- The Health RBC Working Group adopted the 2015 Underwriting Risk Instructions and exposed a proposal on the 2016 Underwriting Risk Instructions.
- The Valuation of Securities Task Force held lengthy educational sessions on derivatives this summer as it considers whether the *Derivative Instruments Model Regulation* should be updated. The task force also discussed ongoing plans to modernize the investment filing process and removal of the SVO from the 5*/6* certification process.
- The International Insurance Relations Committee discussed the results of the NAIC's Financial Section Assessment Program review, which were very positive.
- The ComFrame Development and Analysis Working Group heard updates on the IAIS International Capital Standard and the possible development of an NAIC domestic group capital standard.
- The newly formed Variable Annuity Issues Working Group held two public meetings this summer to discuss additional disclosures for VA captives, which would be effective for 2015 financial statements.
- The NAIC/AIPCA Working Group adopted a white paper entitled *Best Practices: Insurance Regulator Access to Audit Workpapers*.
- The Blanks Working Group adopted twenty-two blanks proposals as final since the Spring National Meeting. A proposal to add a terrorism insurance supplement was adopted by the working group; however, that proposal was subsequently rejected by the Accounting Practices and Procedures Task Force.
- The Reinsurance Task Force heard an update from the XXX/AXXX Captive Reinsurance Regulation Drafting Group on its proposed model law for transactions subject to AG 48.
- In addition to finalizing AG 49 this spring, the Life Actuarial Task exposed several new proposed amendments to the PBR Valuation Manual.

- The Health Actuarial Task Force's Long Term Care Pricing Subgroup completed work on revisions to the *NAIC Guidance Manual for Rating Aspects of the Long-Term Care Insurance Model Regulation*.
- The Financial Regulation Standards and Accreditation Committee adopted a revised definition of "multi-state insurer" to include XXX and AXXX captives effective January 1, 2016.
- The Risk Limiting Contracts Working Group met twice this summer to begin discussions on assessing risk transfer in P/C reinsurance contracts and possibly expanding its charge to include evaluation of the appropriateness of reinsurance contracts in specific circumstances.
- The Risk-Focused Surveillance Working Group finalized guidance which aims to reduce potential redundancies in the financial analysis and examination process. These proposals will be forwarded to the Financial Analysis and Financial Examiners Handbook groups for their consideration.
- The Mortgage Guaranty Insurance Working Group continued work on the proposed revised *Mortgage Guaranty Insurance Model Act* and the *Mortgage Guaranty Insurance Standards Manual*, which the regulators hope to compete by the spring of 2016.

Dedication

This Newsletter is dedicated in memory of John Morris, FSA, MAAA, who greatly contributed to this publication for almost 20 years. He was a good friend to many in the insurance industry and will be greatly missed.

Executive Committee and Plenary

Note: All documents referenced in this Newsletter can be found on the NAIC's website at naic.org.

The Executive Committee and Plenary adopted the following items during a conference call on June 18, which were the subject of public hearings and debate as they were considered by various groups of the NAIC:

- Adopted 2012-2015 amendments to the PBR Valuation Manual
- Adopted Actuarial Guideline XLIX—*The Application of the Life Illustrations Model Regulation to Policies with Index-Based Interest* (AG 49)
- Adopted the Title Insurance Consumer Protection Fund Guideline

The Executive Committee and Plenary adopted the *Stop Loss Insurance, Self-Funding and the ACA* white paper at the Summer National Meeting.

Executive Committee
In Chicago, the committee adopted model law development requests from the Cybersecurity Task Force to consider revisions to the existing *NAIC Insurance Information and Privacy Protection Model Act* and *Privacy of Consumer Financial and Health Information Regulation* to cover cybersecurity expectations and add appropriate cybersecurity protections.

Cybersecurity Task Force

Update Regarding Cybersecurity Legislation
Tony Cotto, NAIC's Financial Policy and Legislation Counsel, provided an update on federal government data breaches and federal cybersecurity legislation. In April and June of 2015, the U.S. Office of Personnel Management discovered two separate but related data breach cybersecurity incidents that impacted federal government employees, contractors and others. It was noted that these breaches, affecting over 22 million individuals, will likely cost the government in excess of $500 million. Separately, the Cyber Information Sharing Act, reintroduced to Congress earlier in 2015, will likely be voted upon in October. While the bill's provisions aid companies' sharing of cyber threats with the government, it does not include data breach

legislation, as there was a lack of consensus in Congress on the matter.

Update from IT Examination Working Group
The chair of the working group discussed the status of the proposed revisions to the Financial Condition Examiners Handbook guidance on technology review. The proposed revisions were re-exposed through September 8, as the working group had received 22 comment letters. The goal of the re-exposure was to incorporate many of industry's comments in the proposed revisions. It was noted that one thematic comment specifically not addressed relates to confidentiality. Although comments expressed the need to include specific language in the section on confidentiality, the chair noted that he considers it unnecessary for specific inclusion in this section as generally all information submitted during examinations is subject to confidentiality protections.

Status of Premera and Anthem Data Breaches
Representatives from Premera Blue Cross provided an update on the status of its data breach remediation efforts. In the months following the breach announcement on March 17, Premera hired an outside firm and has been working with the FBI. To date, Premera is not aware of any public sale or distribution of personal information of approximately 10.5 million customers that may have been compromised during the attack. It has currently enacted the short-term recommended security procedures from the outside firm, and is currently in the planning phase of longer term remediation workstreams, which do not have fixed timelines.

Representatives from Anthem also provided an update, having previously presented during the Spring National Meeting. The update noted that the FBI is familiar with previous attacks by Anthem's hacker, and have stated historically the hacks have been for information gathering rather than monetary benefit. Based on the work of the outside firm and the FBI, Anthem continues to believe that the data of its 79 million customers is not in any public domain, and the company is not aware of any known identity thefts linked to the data breach. Based on the outside firm's 21 remediation plans, Anthem has completed 17 short-term remediation activities, and will work through the end of 2016 on the four remaining longer term plans. To date, Anthem has spent over $65 million in remediation, and expects to spend the same amount in 2016; this excludes a separate $200+ million spent on hiring an outside firm, legal fees and cost of cyber insurance (of which they have begun to collect on its $100 million of coverage). Even with that spend, Anthem acknowledges that the experts still assert they are not immune to future threats.

For both companies, it was reiterated that the board and executives of the company are fully committed to implementing the remediation workplans.

Cybersecurity Bill of Rights Exposure
Comments received to date were shared regarding a new Cybersecurity Bill of Rights, broadly based on the adopted 12 Principles for Effective Cybersecurity Regulatory Guidance. The public comment period ended August 31, and a conference call is expected this fall. The task force noted that the bill of rights are meant to guide consumers, as well as insurers, in understanding what personally identifiable information is being collected, and the procedures to undertake when there is a possibility of identity theft.

Financial Condition Committee

The committee met August 6 via conference call and in Chicago and discussed the following projects.

Survey on Statutory Accounting and the Solvency Framework
In June the committee exposed for comment a survey asking questions related to the following key issues: "1) obtain views on the conservative nature of NAIC statutory accounting, reserving methodologies, RBC and asset valuation, 2) whether NAIC committee processes could be improved to assist in this goal, and 3) whether there are emerging issues that deserve national attention and to consider adding such issues to the agenda of the Financial Condition Committee for analysis and review by all states."

The committee received 26 comment letters from both industry and regulators and discussed comments during its August 6 conference call. The chair began the discussion by noting that the committee had received many thoughtful responses and observing that certain of the questions may have "offended" some individuals. The chair reiterated that the survey was not meant to suggest that permitted practices be eliminated or that the NAIC should end its use of statutory accounting. The intent of the survey was to address "single state solutions to multi-state problems," which the chair has referred to many times in 2015.

The chair summarized common themes expressed in the comment letters, including:

- SAP vs GAAP – most respondents believe SAP and not U.S. GAAP is appropriate for regulatory accounting. One working group member suggested that perhaps conservatism should built into RBC versus accounting principles.
- Hedge Accounting – most commenters believe SAP may be too conservative in this area, which will initially be addressed by the Variable Annuity Issues Working Group.
- Investments – several commenters suggested relaxing investment limitations, while others noted an increase in SSAP 97 permitted practices. The chair noted that it is difficult to find a good balance in this area especially with the pressure on companies from the low interest rate environment.
- Peer review – Although the chair believes it is premature to assign additional oversight duties to the Financial Analysis Working Group, he seemed intrigued by a suggestion from a large life insurer to establish a new oversight group to focus on new permitted practices and whether that topic/issue deserves an NAIC update/revision. Another suggestion that seemed to have support is for the Life and Actuarial Task Force to report periodically to the Financial Condition Committee to increase the flow of information.

The committee has scheduled a conference call for September 17 to review and discuss the comment letters in more detail.

In addition to receiving the reports of its various task forces and working groups, the committee discussed the following significant new projects at the Summer National Meeting.

State of Entry Model Law
The committee has been asked to consider whether revisions should be made to the *State of Entry Model Law* that would subject port-of-entry insurers (i.e. a U.S. branch of a foreign domiciled insurer) to the same accreditation standards of U.S. domiciled insurers. The committee agreed to first perform a survey to get an understanding of what states currently require, and have either an existing or new working group take on the charge.

Regulation of Third Party Administrators (TPAs)
With the Financial Analysis Working Group's ongoing oversight into the causes of troubled insurers coupled with the prevalent use of industry outsourcing, the group is considering whether further oversite of TPAs should occur. Specifically the FAWG is looking into the risk that vendors may not be financially and operationally sound, especially with respect to claims processing, and currently states may not have the ability to investigate their books and records. The committee exposed the FAWG's proposal to study whether the optional audits of TPAs and MGAs should be replaced with a mandatory requirement and whether such a requirement should be an accreditation standard.

Statutory Accounting Principles Working Group

The working group met via conference call June 1 and June 17 and in person in Chicago and discussed the following projects. (After each topic is a reference to the Statutory Accounting Principles Working Group's agenda item number.)

Adoption of Revisions to SSAPs

XXX/AXXX Reinsurance Disclosure (2014-31)
The working group adopted a revised disclosure that requires confirmation that funds for Primary Security and Other Security have been satisfied for all covered policies for reinsurance transactions subject to AG 48. If any shortfalls exist, the insurer would disclose additional detailed information. The new disclosure will be effective for year-end 2015.

SSAP 68 Clarification of Goodwill Limitation Calculation (2015-14) – The working group adopted guidance exposed during its June 17 conference call to clarify that the goodwill limitation test is performed at each individual reporting level.

Wholly-Owned Real Estate and Mortgage Loan Encumbrances (2015-11) – The working group adopted a clarification to SSAP 40R that a "standard mortgage or encumbrance by an unrelated party is not considered a sharing of risks or rewards" and would not otherwise prevent a wholly-owned LLC from being accounted for as real estate.

ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects *(*2014-24)
The working group adopted proposed amendments to SSAP 93 to adopt ASU 2014-01, but to continue the gross income statement presentation. The guidance adopts the "proportional amortized cost" method, which the optional GAAP method under ASU 2014-01.

Update Appendix-821 for 2012 Individual Annuity Mortality Table (2015-12) – During its June 17 conference call, the working group adopted revisions to include the 2012 Individual Annuity Mortality Table in Appendix A-821, *Annuity Mortality Table for Use in Determining Reserve Liabilities for Annuities*, effective January 1, 2015. Because all states have not adopted the 2012 table as of January 1, 2015, interested parties had asked for a January 1, 2016 effective date and to allow either the previous table or the 2012 table for 2015 reporting. However, the working group, at the advice of the Life Actuarial Task Force, did not agree to that change.

Medicare Advantage and Medicare Part D Adjustment Premium Receivables and Payables (2014-27) – At the Spring National Meeting, the working group voted to expose a proposal to revise SSAP 54, paragraph 30, to record Medicare Advantage and Park D premium adjustments through premiums receivable (increases) or reserve liabilities (decreases) with an offset to written premium, as opposed to adjustments to aggregate write-in lines and unearned premium reserves. This guidance was adopted during the June 17 conference call.

SSAP 25 Disclosures (2014-36) – The working group adopted guidance to reject ASU 2013-06, *Not-for-Profit Entities; Services Received from Personnel of an Affiliate*. The working group had previously exposed a proposal to require disclosure of the fair value of services received or transferred by the insurance entity with an affiliated entity. The working group subsequently directed staff to determine whether services between affiliates at no cost are disclosed in Form B/D filings, and will discuss next steps after staff reports back.

ASU 2010-23, Health Care Entities, Measuring Charity Care (2015-01) – The working group adopted the ASU definition of "charity care" as part of SSAP 54 and adopted, with modification, the disclosure required by the standard. The proposed disclosure provides less detail (compared to the GAAP disclosure guidance) on the types of techniques that may be used to estimate the cost of charity care.

Technical Edits to APP Manual (2015-09) – The working group voted to adopt technical edits to the APP Manual to clarify intent. The most significant adopted change is to SSAP 106 for the ACA section 9010 disclosure to clarify that disclosure of the impact of the risk-based capital sensitivity test in the RBC formula relates to the effect on Total Adjusted Capital only (not Authorized Control Level RBC).

SSAP 24, Discontinued Operations and Extraordinary Items (2015-06 and 2015-07) – The working group adopted with modification both ASU 2015-01, *Income Statement, Extraordinary and Unusual Items* and ASU 2014-08, *Reporting Discontinued Operations*. The first ASU eliminates the concept of extraordinary items; the modifications proposed by the working group would continue to disallow discontinued operations being shown separately from continuing operations in the income statement. Entities will now disclose events that are unusual, infrequent or both in the financial statements.

Exposure of New Guidance and Discussion of New and On-going Projects

Comments on exposed items are due to NAIC staff by October 2 unless otherwise noted.

SSAP 97, Nonadmitted Assets and Application of the SAP Guidance to SCAs (2015-08) – At the Spring National Meeting the working group discussed a significant new project to reconsider conclusions reached in SSAP 97 and requested feedback from regulators and the industry on three issues. After lengthy discussion during its June 17 conference call, the working group agreed to expose for comment "limited, nonsubstantive revisions to incorporate concepts within SSAP 97 that seem to be consistent with industry practices." Details of the proposals exposed for comment at the Summer National Meeting include the following:

- Nonadmitted Assets in Non-Insurance SCAs – Proposed revisions to several paragraphs of SSAP 97 would add guidance that paragraph 16d of SSAP 25 be explicitly considered in determining the carrying value of an SCA. That guidance requires that "transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary." This replaces a more onerous proposal to restrict the amount of assets held in an SCA that would not be admitted assets if held directly by the reporting entity.

- Valuation of U.S. Insurance SCAs – In lieu of another proposal to reverse the surplus effect on the insurer company parent of an insurance SCA with state prescribed or permitted practices that deviate from the NAIC SAP, the working group instead proposed additional disclosures in the financial statements of the insurer parent. Those parent entities would disclose the following: 1) a description of the state prescribed or permitted practice followed by the insurance

SCA entity, 2) the effect on net income and surplus of the practice on the insurance SCA entity, 3) whether an RBC level event would have been triggered without the practice, and 4) the carrying value of the investment in the insurance SCA by the parent with and without the prescribed or permitted practice.

- Valuation of Non-Insurance SCAs Engaging in Insurance Activities and Foreign Insurance Entities – The working group had considered whether SCA entities valued in accordance with paragraphs 8b.ii and 8b.iv of SSAP 97 should be adjusted to a "full statutory accounting basis" or be revised to reflect additional SAP adjustments. The working group concluded full conversion to NAIC SAP is not necessary, but exposed for comment some additions to the current six adjustments to audited U.S. GAAP carrying value, which include the following: nonadmit assets that do not meet the requirements of SSAP 21 and SSAP 105, expense any pre-operating and research and development costs that had been capitalized for GAAP, amortize goodwill in accordance with SSAP 68 and nonadmit any surplus notes held by the SCA that have been issued by the parent insurer.

The working group anticipates the three proposals will be adopted later this year and will be effective for 2015 annual and audited financial statements.

<u>SCA Filing Guidance (2015-25)</u> – In response to a survey to regulators which found that the "vast majority" support receiving additional information on SCA filings, the working group voted to expose for comment a proposal to move the SVO guidance on SCA filings from the SVO Manual to SSAP 97 as an appendix. More significantly, the proposal would also require additional disclosures for each SCA investment: "SCA balance sheet value (admitted and non-admitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, whether resubmission of filing is required)."

<u>Application of the Equity Method (2015-32)</u> – As a result of many questions received by NAIC staff on the application of the equity method to SCA investments, the working group exposed for comment proposed clarifications to paragraphs 10-12 of SSAP 97 to reflect the original intent of the guidance.

<u>Investment Classification Review Project (2013-36)</u>
Since 2013 the working group has been reviewing the investment SSAPs to consider clarifications of definitions, scope, accounting methods and reporting guidance. At the Spring National Meeting, the working group exposed four discussion documents related to a proposal to adopt the GAAP definition of a "security," require all SSAP 26 investments to have a "contractual amount of principle due," an analysis of exchange-traded fund investments (ETFs) approved for reporting as bonds or preferred stocks, and definitions for debt-like investments that would not meet the proposed new definition of a security in SSAP 26 including loan participations, loan syndications, TBA securities, and hybrid securities.

At the Summer National Meeting the working group asked staff to begin work on a new issue paper that will include proposed adoption of the U.S. GAAP definition of a security and definitions for other debt-like investments that fall outside the "security" definition. The working group also exposed a comment letter from BlackRock proposing an alternative to the use of fair value for investments in ETFs, using an amortized cost valuation methodology similar to that of other fixed income investments with multiple individual positions and fluctuating cashflows. The comment deadline on the BlackRock proposal is September 11.

<u>Prepayment Penalties and Amortization on Callable Bonds (2015-04)</u> – At the Spring National Meeting, the working group voted to expose new guidance to require prepayment penalties and acceleration fees to be reported as realized capital gains, clarify the yield-to-worst concept for continuously callable bonds, and revise the guidance for bonds with make-whole call provisions. As a result of significant comments received, the working group decided to bifurcate the issues and create two agenda items.

- Prepayment penalties and acceleration fees (2015-23) – Two comment letters strongly objected to the proposal to change the reporting of these amounts from net income to realized capital gains and a third comment letter supported the change with a clarification that the gain be subject to IMR. As a result, the working group exposed for comment three alternatives: 1) maintain current accounting as net investment income, 2) report as realized capital gains subject to IMR or 3) report as realized capitals but excluded from IMR. If any change is adopted, interested parties asked that the change be adopted prospectively.

- Clarification of yield-to-worst calculation for callable bonds (2015-04) – Comment letters also objected to this proposal for insurers to consider make-whole call provisions in the yield-to-worst amortization calculation as it would be costly to implement since the hypothetical carrying value (based on interest rates and changes to the call

price) could fluctuate daily. The working group revised the proposal and re-exposed a conclusion that the make-whole provisions should not be considered in determining the timeframe for amortizing premium or discount unless the insurer is aware that the issuer expects to invoke the make-whole call provisions.

Quarterly Reporting of Investments (2015-27) During its June 17 conference call, the working group asked for input from interested parties about requiring full investment schedules on a quarterly basis in electronic only format. A representative from the SVO's Capital Markets group noted it would be "extremely beneficial" to have this level of detail on a quarterly basis. In its comment letter discussed at the Summer National Meeting, interested parties strongly disagreed with the statement in the Form A that requiring the full investment schedules "would not be an overly difficult task for reporting entities," and noted that the "investment schedules represent the most time consuming part of the Annual Statement, whether completed electronically or in print." As a result of the discussion, the working group asked for suggestions on what data should be captured (in lieu of asking for full investment schedules), considering both cost concerns and regulatory benefits.

Measurement Method for NAIC 5 Designated Bonds (2015-17) – The working group voted to expose for comment a proposal for AVR companies to report SSAP 26 and SSAP 43R NAIC 5 designated bonds at the lower of amortized cost or fair value, to make the valuation method consistent with non-AVR filers. This would change the statutory measurement basis that been used for decades by life and health insurers. Based on 2014 financial statements, the proposed change would affect 1,574 securities.

Holders of Surplus Notes (2014-25) – At the Summer National Meeting, the working group voted to expose for comment Issue Paper 151, *Valuation for Holders of Surplus Notes*. The issue paper includes the following guidance: 1) NAIC 1 rated surplus notes would continue to be reported at amortized cost, and 2) unrated surplus notes or those rated other than NAIC 1 would be valued at the lower of cost or fair value. This would eliminate the concept of reporting the notes at outstanding face value or a calculated amount based on a statement factor; explicit guidance on other-than-temporary impairments is also proposed. Valuation changes would be reflected as changes in unrealized gain or loss unless the surplus note is OTTI. The issue paper asks for input as to whether NAIC 2 surplus notes should be valued at amortized cost. Issue Paper 151 notes that for year-end 2014, 149 surplus notes were held by insurers, of which 96 were rated NAIC 1 and 42 were classified as NAIC 2. The proposed effective date is January 1, 2016.

ASU 2015-09, Insurance, Disclosures about Short-Duration Contracts (2015-37) – The working group exposed a request for regulators and industry to comment on whether statutory disclosures should be revised to adopt these new GAAP disclosures, which are part of the FASB's "targeted improvements" to U.S. GAAP for insurance contracts, effective for public companies at year-end 2016. Interested parties commented that they will be forming a study group to compare the ASU disclosures to those required by statutory reporting, including Schedule P disclosures. A representative noted that it would be a lot of work to do the ASU 2015-09 disclosures at the legal entity level. The working group is also interested in hearing comments on whether Schedule P and other statutory claim and loss reserve disclosures are already substantially compliant with the ASU guidance for purposes of U.S. GAAS OCBOA (other comprehensive basis of accounting) disclosure requirements.

Variable Annuity Captive Disclosures (2015-36) The working group exposed for comment proposed significant new disclosures for variable annuity captives for year-end 2015 financial statements. See summary of the meeting of the Variable Annuity Issues Working Group for additional discussion.

Sale-Leasebacks with Non-Admitted Assets (2015-03) – During the Spring National Meeting the working group asked for comments as to whether the guidance in SSAP 22 was intended to allow the sale/leaseback of nonadmitted assets with unrelated parties, which results in an increase to surplus. The working group received two comment letters (AICPA and interested parties) noting that paragraph 27d of SSAP 22 specifically permits sale/leaseback transactions of nonadmitted assets with third parties. At the Summer National Meeting, the working group decided to defer further discussion until the FASB's issues its revised lease accounting standard.

Consideration of FAS 133 EITFs (2015-22) – In connection with researching another issue, NAIC staff realized that it is unclear which interpretations of the FASB's Derivatives Implementation Group have been considered by the working group. At the Summer National Meeting, the working group directed staff to note all EITFs as "pending" in Appendix D of the APP Manual and begin preparing agenda items for the working group to consider.

Asbestos and Environmental Exception Reporting (2011-45 and 2014-28) – For 2013 reporting, the working group adopted accounting guidance for SSAP 62R related to the Schedule F penalty for asbestos and pollution contracts that have duplicate coverage, which results in a decrease in the overdue liability when the requirements are met. However, the regulators have been struggling for months to finalize the guidance and instructions for Schedule F and again changed course over the summer. At the Spring National Meeting, the working group voted to re-expose for comment the more-detailed Option 1 for reporting with modifications to paragraphs 66-68 of SSAP 62R. During its June 1 conference call, the working group voted to return to Option 2, which CNA, AIG and some regulators believe is more transparent regarding the management of the credit risk related to the ongoing business, and exposed a revised proposal for comment. This results in the related annual statement changes being deferred from 2015 to 2016. At the Summer National Meeting, the working group exposed additional revisions and a proposed Schedule F illustration for comment until September 11.

Insurance-linked Securities (2015-34) – The working group requested information on the use of insurance-linked securities, such as catastrophe bonds, and exposed for comment proposed disclosures that are being considered when a triggering event has occurred.

Short Sales (2015-02) – At the Spring National Meeting, the working group asked for comments from regulators and industry on whether short sale transactions should be permitted by insurers; SSAP 86 on derivatives is silent on this topic, and some state investment laws explicitly prohibit insurers from entering into short sales. Interested parties commented that they are not aware of significant use of short sales by insurance entities. However, during its June 17 conference call, the working group asked staff to proceed with an issue paper due to the number of questions received by NAIC staff. Substantive discussion is expected at the Fall National Meeting.

Foreign Currency Translation for Canadian Insurance Operations (2015-24) – NAIC staff reported they have received questions with regard to SSAP 23 and whether it is optional for insurers to translate Canadian operations making a single adjustment to net assets, as opposed to making line by line translations of financial statement items. Based on the guidance in the Issue Paper on foreign currency, staff concluded that it was intentional to provide optionality. As a result, the working group is proposing a revision to paragraph 5 of SSAP 23 to clarify this. The working group also requested comments on revising the annual statement and instructions to eliminate cross check errors related to foreign currency translation.

ASU 2015-04, Practical Expedient for the Measurement Date of An Employer's Defined Benefit Obligation and Plan Assets (2015-03) – During its June 17 conference call, the working group voted to reject this ASU as it allows a fair value measurement date of other than December 31. At the Summer National Meeting, the working group heard comments from industry that the ASU provides helpful guidance for interim re-measurement of plan asset and liabilities when a significant event occurs. As a result, the working group re-exposed proposed changes to SSAPs 92 and 102 to include guidance on interim re-measurement (but not allow these re-measurements to be used for year-end valuations).

Disclosures for High Deductible Policies (2015-35) The working group discussed a referral from the Financial Analysis Working Group which has noted an increasing credit risk with respect to high deductible policies such as workers compensation, whereby the insurer pays the full amount of the claim and then is reimbursed by the policyholder. The working group exposed for comment a proposal to expand the disclosures to identify the top ten obligors under high deductible policies, unsecured receivables that exceed 3% of surplus and when the obligors are part of a professional employer organization.

SSAP 55 Proposed Revisions – The working group considered two proposed changes to SSAP 55 guidance on salvage and subrogation recoveries (2015-21) and title insurance disclosures (2015-29) and exposed them for comment. Fees to recover salvage and subrogation should be reported gross regardless of whether the fees are paid to third parties or are allocated internally. With respect to title insurance disclosures, the instructions would be modified to refer to "known claim reserves" (line 1 of the liabilities page) for the loss reserve development information.

SSAP 107 Revisions (2015-30) – The working group exposed for comment proposed changes to the SSAP 107 risk adjustment receivables and payable guidance to be consistent with the guidance adopted for SSAP 54 related to Medicare Advantage and Part D receivables and payables as discussed above.

Quarterly Reporting of Restricted Assets (2015-19) During its June 17 conference call, the working group proposed expanding the quarterly disclosure of restricted asset to be consistent with the new annual note. In Chicago, the working group reviewed comments from interested parties who believe this

proposal would be inconsistent with the statutory Preamble, which requires quarterly detail only when there has been a significant change since year-end. The working group agreed and directed staff to revise the proposal accordingly.

PBR Issue Paper – The working group directed staff to begin the Principles-Based Reserving Issue Paper and asked for assistance from regulators and interested parties.

ASU 2015-05: Customer's Accounting for Fees Paid in a Cloud Computing Arrangement (2015-15) – The working group agreed with the interested parties' suggestion to defer consideration of this guidance until the FASB finalizes its revised lease accounting guidance.

Non-recourse charity loans (2015-31) - The working group asked for feedback from interested parties with regard to obligations issued by charitable organizations which the entity does not have any responsibility to support the timely payment of principal or interest. The Valuation of Securities Task Force noted that some of these instruments have been filed by insurers and asked for input from the SAP Working Group.

Proposed Rejection of Recently Issued ASUs – The working group voted to expose for comment rejection of the following U.S. GAAP guidance: *2015-03, Simplifying the Presentation of Debt Issuance Costs* (2015-10) and *ASU 2011-10, Derecognition of in Substance Real Estate* (2015-26).

Aging and Revenue Recognition of Multi-Peril Crop Policies (2015-33) –The working group asked for information from interested parties, regulators and the USDA Risk Management Agency on revenue and receivables related to crop insurance.

Long Outstanding Items on the SAP Maintenance Agenda – In Chicago, the working group addressed the following old items on the agenda as follows:

- Re-exposed a proposal to reject FAS 159, *The Fair Value Option for Statutory Accounting* (2007-25)
- Proposed disposal of issue 2004-17 on Clarification of Accounting and Reporting Guidance for Financial Instruments Used to Hedge Options Embedded in Variable Annuity Guarantees as this agenda item was resolved by the adoption of Actuarial Guideline 43, *CARVM for Variable Annuities.*

Restricted Asset Subgroup Report
The subgroup met May 13 via conference call to hear an educational session from interested parties on repurchase agreements, which included discussion of the mechanics of a repurchase agreement, documentation, current accounting and management of risks. The session was in response to the subgroup's preliminary recommendation to diverge from U.S. GAAP and remove transferred securities under repurchase agreements from the financial statements; however, as a result of additional discussions with industry, the proposal is not moving forward at this time. The subgroup is developing enhanced disclosures for repurchase transactions, which they hope to finalize and expose for comment on a conference call in September (which is not yet scheduled).

Proposed Policy Changes (2015-18) – The working group exposed for comment a proposal to disband the Emerging Accounting Issues Working Group and bring the two members of EAIWG not on the SAP Working Group (Alabama and Connecticut) onto SAPWG. The process to issue INTs will be continued by the SAP Working Group. The regulators are also exposed proposed revisions to the Policy Statements to reflect this change and clarify other processes.

Next Conference Call
The working group has scheduled a conference call for September 24; issues to be discussed on that call include the BlackRock ETF valuation proposal and the SSAP 62R/Schedule F proposal for asbestos and environmental coverages.

Principles-Based Reserving Implementation Task Force

PBR Adoption by States and "Substantially Similar" Considerations
The task force co-chair reported that, as of the Summer National Meeting, 36 states have adopted the principles-based reserving requirements, which represents 60% of direct U.S. premium. This represents a significant increase since the Spring National Meeting totals of 23 states and 37% of premiums. As a result, the task force is still recommending the use of January 1, 2017 as the earliest probable PBR Valuation Manual effective date, which they stated is still "quite possible." For the Valuation Manual to become effective, 42 states representing 75% of premiums must adopt the PBR requirements in accordance with, or with terms "substantially similar" to, the Standard Valuation Law.

In Chicago, the task force discussed a proposed process for monitoring and assessing whether a state's PBR laws are "substantially similar" to the SVL consistent with Accreditation Standards criteria. The proposal, which was developed by a drafting group of the task force members, was exposed for a comment period ending September 16. Under the proposal a five step determination process would be followed, including: (1) a survey of each state to document its conformance and deviations from the SVL, (2) a validation process to be performed by a subset of task force members to assess the accuracy of each survey response, (3) a task force level evaluation, (4) the task force would make a recommendation to Plenary once it has concluded that a sufficient amount of state laws comply with the SVL for the Valuation Manual to become operative, and (5) Plenary would make the final determination as to whether a state will be counted toward the critical threshold and when the Valuation Manual is operative.

PBR Pilot Project
The chair discussed the NAIC's plans for a PBR pilot in 2016 which would evaluate regulatory processes and company submissions, and propose revisions to the regulatory review process and the Valuation Manual as necessary based on lessons learned. The NAIC is looking for companies who plan to implement PBR immediately upon implementation, especially those which write term and/or universal life business with secondary guarantees. The PBR Review Working Group will be working with NAIC staff to draft a "recruiting letter" for states to send to their domiciliary companies and will also be working with states on confidentiality issues and reviewing company submissions.

PBR Experience Reporting Framework
The task force heard an update from NAIC legal staff on the Framework which addresses data collection and dissemination under PBR; staff noted that they are encountering more difficulties than they first estimated. Issues include required state procurement procedures and the ability of states to direct data filings to third parties. One suggested solution would be for the NAIC to collect the data. Research into this and other potential solutions will continue.

XXX/AXXX RBC Disclosures
The task force discussed a May 8 letter from the Life RBC Working Group asking for direction on a recommendation from two interested parties that ceding companies with XXX/AXXX captives disclose, beginning with year-end 2015 financial statements, total adjusted capital and authorized control level RBC for all captives subject to AG 48. (Grandfathered XXX/AXXX captives would not be required to make this disclosure.) The chair of the task force agreed the disclosure is a "good idea" and asked the ACLI for comments. The ACLI representative replied that such a disclosure could be misleading and that there is not enough time to develop a modified proposal and meet a 2015 deadline. He suggested as an alternative, ceding companies could disclose whether any captives have a RBC shortfall (a new calculation that has been adopted for 2015 RBC filings) and the amount of the shortfall. The ACLI representative agreed to discuss the proposal with its members and engage in additional discussion this fall.

Next Meeting
The task force has scheduled a conference call for September 30 and plans to consider adoption of the VAWG Process & Procedures Manual drafted by the Valuation Analysis Working Group. See the summary of the PBR Review Working Group for additional discussion.

Capital Adequacy Task Force

2015 RBC Formulas and Instructions
The task force met April 30 and June 30 with the primary goal of adopting proposed revisions to the 2015 RBC formulas and instructions. In total, the task force adopted 14 proposals for 2015, the most significant of which are discussed in the summaries of the RBC Working Groups below (or in prior PwC NAIC Meeting Notes Newsletters). The task force also adopted a process to post all adopted RBC proposals to its webpage until November 1 of each year

Receivables for Securities Factor (2015-09-CA)
The task force itself initiated and adopted several proposed changes to 2015 RBC, the most significant of which was the 2015 factors for receivables for securities, which are now revised annually beginning in 2014. The 2015 factors adopted are as follows: 1.4% for life RBC, 2.7% for P/C RBC and 2.6% for health RBC, which are calculated on pro-rata basis using asset allocations as of the prior year-end.

Restricted Assets on Deposit
During its April 30 conference call the task force agreed to add to its working agenda a referral from the SAP Working Group to consider whether assets held on deposit with states should have a higher RBC charge than other restricted assets when an insurer has a significant amount of assets on deposit.

Affiliated Investments
At the Summer National Meeting, the task force discussed a referral from the P/C RBC Working Group asking that the task force designate a

subgroup to review the Affiliated Investments page for consistency in all four RBC formulas. (See the P/C RBC Working Group summary for further detail.) After discussion with the chair of the task force, the Investment RBC Working Group agreed to an initial review of the affiliated investments charge in all four RBC formulas, and plans to discuss it during its September 8 conference call.

Life Risk-Based Capital Working Group

The working group has been especially diligent since the Spring National Meeting; the regulators met seven times via conference call with the primary goal of finalizing and adopting its three XXX/AXXX Reinsurance Framework RBC proposals (including the related instructions), which are discussed below. The working group also met at the Summer National Meeting and significant topics discussed in Chicago are also covered.

XXX/AXXX Reinsurance Framework Referrals
The working group had been asked to consider issues related to the Framework by the PBR Implementation Task Force and has spent nearly all of its time in 2015 discussing these proposals. During its April 22 conference call, the working group adopted the structural changes to the formula to implement the reinsurance framework proposals and then worked to develop and finalize the instructional guidance by the June 30 deadline, working closely with the ACLI. The three AG 48 proposals adopted by the working group and the Capital Adequacy Task Force during its June 30 conference call are summarized below.

Qualified Actuarial Opinion (2014-33-L-Mod) – AG 48 requires a qualified actuarial opinion in certain circumstances. Because a qualified opinion would otherwise increase RBC factors for reserves subject to Interest Rate Risk and Market Risk, the working group adopted revisions to LR027 to avoid impacting all lines of business of the ceding company "for a qualification of the Actuarial Opinion due solely to the direction provided in AG 48."

Primary Securities Shortfall (2014-35b-L-Mod) This proposal increases captive entity authorized control level RBC dollar for dollar by the amount of any shortfall of Primary Securities with no offset for any surpluses. A new schedule showing primary security shortfall by individual cession has been added to the formula.

RBC Shortfall (2014-42-L-Mod) – This proposal applies to the ceding company's RBC calculation and adds a new schedule to show the calculation of the RBC AG 48 shortfall for all captives with an adjustment to total adjusted capital with no offset for surpluses. Benchmark RBC level has been set at 300% of authorized control level for each captive.

The working group will continue to refine an approach to incorporate consideration of AG 48 Other Securities into either a stand-alone proposal or into the calculation in the RBC shortfall. For 2015 filings, other securities are given no value in these calculations. Additional work is needed to refine the presentation of the consolidated RBC. For 2015 filings, the consolidated column on the RBC shortfall schedule is "XXX'd out" with the exception of the shortfall amount.

Derivatives Collateral Proposal (2014-32-L)
The working group adopted this proposal for 2015 RBC filings during its April 22 conference call; the goal of proposal is to implement consistent reporting of cash pledged as collateral for derivative transactions and to eliminate the over-charging of risk for cash collateral. The proposal excludes cash collateral pledged for derivative transactions from a separate RBC charge and implements a new "centrally cleared" derivatives category for RBC and AVR, which are assessed a 0.4% RBC charge.

C-3 Phase II Informational Filing
The working group discussed a proposal from the ACLI asking that the C-3 Phase II informational filing not be required for 2015. In 2014, companies meeting certain criteria were required to submit alternative amounts using stochastic modeling based on the American Academy of Actuaries' economic scenario generator or the company's internal ESG, if available. The goal was to obtain data that would be analyzed and used to update the C-3 Phase I methodology. However, the data was not examined in detail; therefore the ACLI requested that the time-consuming filing not be required for 2015. The working group agreed.

C-3 Phase II/AG 43 (E/A) Subgroup Update
This joint subgroup is charged with evaluating the overall effectiveness of capital and reserve requirements for variable annuities and presenting recommendations to improve the effectiveness of those requirements. At the Spring National Meeting, the chair reported that Connecticut would be assisting with a field test on different alternatives for C3P2. At the Summer National Meeting the chair reported that the subgroup continues to struggle to address its broad charge and noted that the new Variable Annuities Issues Working Group will be looking at what is motivating the use of captive reinsurers for variable annuities and will be analyzing some of the same issues that the subgroup has considered. As a result the subgroup will wait

and see how the VA Issues Working Group moves forward with its charges.

2014 Life/Fraternal RBC Results
The working group reviewed the results of 2014 filings noting they are consistent with prior years, with 2.5% of companies triggering an RBC level event and median RBC of 1066%. The chair observed that the working group has not recently used this data to help guide its work and priorities. He suggested that some analysis be done on companies that triggered action levels or trend tests to determine what issues contributed to those events as a way to assess if the formula is doing what it is supposed to do.

Operational Risk
At the Spring National Meeting, the working group agreed to take on a project to make operational risk more granular for the life RBC formula. In Chicago, the working group discussed several options in approaching the project such as asking the Society of Actuaries to do a research project using Delphi methods or other analysis to assess how much of operational risk is already captured in the formula. No conclusions were reached.

New Chair
The long-time chair of the working group, Mark Birdsall, resigned as chair in June as he was leaving the Kansas Insurance Department; the working group is now chaired by Philip Barlow of Washington DC.

Stress Testing Subgroup

The Stress Testing Subgroup's charges are to consider changes needed to RBC in light of PBR, and to consider a total balance sheet approach to evaluating capital adequacy and application of stress scenarios. The subgroup held a conference call in July to discuss comments received on the Stress Testing Proposal which sets forth an approach for evaluating the adequacy of the statutory total asset requirement (TAR) under adverse conditions. The proposal calls for establishing best estimate assumptions for all modeling factors and identification of key risk drivers for purposes of stressing the best estimate assumptions to extreme levels. These assumptions would be applied to develop threshold amounts for testing the adequacy of the statutory TAR.

Comments on the proposal indicated concern over the complexity of the proposal and potential expense to implement. The ACLI noted that the NAIC's Solvency Modernization Initiative did not call for wholesale changes to RBC and it would be important that a such a proposal be evaluated in conjunction with requirements under the ORSA and that it be subject to high-level NAIC review and support before extensive resources are invested in testing it. The subgroup will continue to evaluate how best to respond to the charges, particularly the essential charge to consider changes needed to RBC in light of PBR. While the subgroup noted early 2018 as a potential target date to have changes in place, no specific timeframes for interim steps were discussed.

Investment Risk-Based Capital Working Group

The Investment RBC Working Group held conference calls on June 9 and July 23 and met at the Summer National Meeting. The working group is focused on many priority topics, as discussed below.

Corporate Bonds
At the 2015 Summer National Meeting, the AAA formally presented its recommendation of C-1 factors for corporate bonds. The AAA's preliminary factors were presented at the 2014 Summer National Meeting based on 19 credit rating categories common among the leading bond rating organizations. The revised factors presented in Chicago have been compressed into 14 categories reflecting the AAA's proposed base factors which would increase granularity by expanding the current 6 NAIC designations. Under the increased granularity approach, current NAIC designations are expected to utilize a "+" and "-" indicators to expand the number of designations for categories 1-4 (e.g., 1+, 1, 1-); NAIC 5 and NAIC 6 designated bonds would not have +/- indications. C-1 factors for corporate bonds in or near default (NAIC 6 designated) were not subject to the AAA's modeling; however, the AAA recommends that this category continue to have a C-1 factor of 30%, consistent with equity securities. Other than compressing the base factors, the AAA observed that there were only minor revisions to those factors presented in 2014.

In general the AAA's proposed C-1 factors are higher for investment grade corporate bonds and generally lower for below investment grade bonds as compared to the current C-1 factors. Of the seven rating classes that show a decreased factor, six are NAIC 3 or below. Over the summer, the AAA completed its efforts to reconcile the current C-1 factors to the AAA's proposed factors. The significant drivers, explained by the AAA quantitatively, include the change in the discount rate, as well as changes in default and recovery experience since 2002, when the factors were last assessed. Reduced recovery experience on NAIC 1 and NAIC 2 designated bonds was the primary contributor to the increase in these

C-1 factors, while improved default and recovery experience each contribute to the decrease in the proposed C-1 factors for the remaining NAIC designations (3-5). The Academy's recommendation is based on analysis of 20 years of trailing default and recovery data run through a 2,000 trial simulation to pre-fund cumulative losses in each rating category over a 10-year period to a 95% confidence level.

Using the proposed new factors, the NAIC has roughly estimated that life RBC for C-1 risk could increase 30%-50% and the ACLI is estimating larger increases. As summarized by the chair in her letter to regulators and interested parties dated August 3, "The current structure includes three-fold increases in the factor between NAIC 1 and NAIC 2, and between NAIC 2 and NAIC 3. The 20 year old RBC now in place gives incentive for insurers to over-invest in bonds at the lower end of each rating bucket. The calculations done 20 years ago assumed that industry exposure would be 25/25/50 split between AAA/AA/A for the current NAIC 1 Designation, whereas investing is heavily skewed to single A. That is partly due to market availability but also because the capital factor is lower than it should be versus the risk taken."

While the working group has indicated support for the increased granularity of the C-1 factors, the ACLI is advocating for retention of a six-factor approach. The ACLI argues that it is unclear that the benefits of further granularity are justified, giving consideration to the additional costs which would be incurred by the industry and the NAIC in order to implement such a change. Further, the ACLI observes that a change from the current six-factor approach would delay implementation of new factors by at least two years. The ACLI does acknowledge that the industry is not unanimous in its opposition, and that some life companies agree that the proposed expanded granularity is a better system in the long run by better aligning the RBC framework with investment risk. Additionally, corporate organizations with more than one type of insurance argue that there should be consistency with respect to granularity across life, health and P/C insurers.

The working group exposed the AAA's *Model Construction and Development of RBC Factors for Fixed Income Securities* which documents the AAA's considerations, assumptions and methodology used to develop its recommended C-1 factors for a comment period ending September 29. The recommendations also include proposed AVR factors.

Private Placement, Sovereign and Municipal Bonds

In performing its analysis and developing its recommended base factors, the AAA relied on available data for the public corporate bond segment. Further, the AAA's recommendation is that private placement, sovereign and municipal bonds should carry the same RBC factor as public corporate bonds. This view was formed in part by its discussions with nationally recognized statistical rating organizations, who note that they utilize a global ratings methodology; thus the factors for all fixed income securities rated by a given NRSRO are expected to have comparable non-performance risk. However, the ACLI and other interested parties have observed that credible data exists to support that private placement bonds, sovereign debt and municipal bonds each have better loss experience when compared to public corporate debt.

In its August 7 letter to the working group, the ACLI expresses support for a single set of bond factors; however, the industry group argues that the C-1 factors as proposed by the AAA are too high because they do not incorporate the experience of other fixed income asset classes. The ACLI points out that public corporate bonds constitute approximately 50% of all bonds reported by life insurers on Schedule D, and therefore ignoring the experience of other fixed income securities is not appropriate. Acknowledging that loss experience data for other asset classes is not as robust as is available for public corporate bonds, the ACLI outlines a proposed framework which would develop composite factors reflecting experience from each asset class based on both its percentage of overall portfolio exposure and the relative experience or robustness of the data. For example, the relative experience rating for private placements, which constitute approximately 25% of Schedule D assets, might be 75%, while the relative experience rating for public corporate bonds would be 100%.

Asset Concentration

In July, NAIC staff provided the working group with an overview of the current asset concentration factor for life, P/C and health insurers, which are intended to reflect the additional risk of high concentrations in single exposures or issuers. In response to questions from the working group, staff noted that a tool does not currently exist to aid in the aggregation of issues into a common issuer, particularly with respect to entities under common control, for the purpose of determining top concentrations, and the process remains largely manual. Staff also reviewed life and P/C companies' size factor adjustment, which reflect risks inherent in the number of positions within a portfolio and decreases as portfolio the number of positions increase. A size

factor adjustment does not currently exist in the health RBC formula.

While the life RBC formula does include an asset concentration factor that doubles the C-1 factor (up to 45%) for the 10 largest asset exposures (excluding stocks, as there is a separate stock concentration factor), the AAA is considering whether to recommend a separate asset concentration factor specific to bonds. The number of issuers and the variation in size of the issuers contribute to variations in portfolio risk; because only one set of factors has been developed without consideration of a given life insurer's bond portfolio composition, it may be appropriate to further adjust RBC to account for these variations.

Real Estate
The working group exposed a revised proposal developed by the ACLI which would decrease the current based factor for all real estate from 15% to 8.5%. The ACLI's prior proposal recommended a factor of 8%, which was developed using a price variation analysis of what is perceived to be reliable real estate industry data. However, concerns were expressed by some members of the working group that that the significance of the decrease in the base factor might incentivize insurers to increase their exposure to this less-liquid asset class.

The working group had preliminarily concluded that the base factor should be adjusted to reflect variable property type risk (beta factor). However, after considering feedback from the ACLI on the implementation challenges of a beta factor on a relatively small investment class, the working group was expected to support the increase in the base factor to 8.5% rather than adding a variable beta factor. According to ACLI modeling results, an increase in the base factor from 8% to 8.5% increases the confidence level from 95% to 97%. During its September 8 conference call the ACLI provided a detailed presentation of the real estate charge proposal (which had been scheduled for Chicago but the working group ran out of time). During that call, the chair of the working group suggested that the ACLI should consider further increasing the base charge to 10%. The comment period for the revised proposal ends September 29.

Schedule BA Assets
The working group is also considering possible revisions to RBC charges for Schedule BA asset and has noted the significant growth of these assets over the past few years. The working group expects to review seven of the 40 Schedule BA categories, which represent approximately 77% of the industry's Schedule BA assets. Additionally, definitions for private equity and hedge funds are being developed as definitions do not exist in the current guidance.

Implementation
Because implementation of new factors will require significant discussion and coordination among at least several NAIC groups, the timeline for implementing any new life RBC C-1 factors remains uncertain. One former regulator has suggested a two phase implementation. The first phase would be to update the C-1 factors aligned to the current 6 NAIC ratings designations and could be implemented quickly (possibly for 2016). The second phase would implement the increased granularity providing for a reasonable transition period. The working group has not reacted to the informal proposal; however given the industry's current opposition to increased granularity, such an approach may be necessary to reach consensus. The ACLI has commented that the earliest that the life industry could implement any changes to the rating structure for RBC purposes would be for year-end 2018.

Health RBC Considerations
Prior to June, the work performed by the AAA with respect to bonds was principally for the purpose of developing proposed C-1 factors for the life RBC formula; the AAA had not explicitly evaluated how its work should be considered for the purposes of the P/C and health RBC formulas. On the working group's June 6 conference call, the AAA's Health Solvency Working Group (HSWG) outlined several approaches and options for the analysis of asset risk factors for the health RBC formula. The AAA's HSWG will be meeting monthly to develop recommended fixed income asset risk factors for the health RBC formula. The Health RBC Working Group has formed its own ad hoc group to review the asset charges for the health RBC formula; it is not clear how these two group will interact. It is also unclear whether an analysis will be performed by the AAA or the NAIC to separately consider the P/C RBC factors, or if the proposed health RBC factors might be leveraged for the P/C RBC formula.

Operational Risk Subgroup

The subgroup met three times by conference call in April, June and July. During the conference calls, the subgroup discussed the following topics.

Cybersecurity - From the insurance regulatory perspective, the primary concerns are harm to the consumer when 1) an agency or insurance company's policyholder data is hacked, and/or 2) information that is stored at the NAIC or at a state government agency is compromised. The subgroup has not concluded whether to consider cybersecurity risk as

a component of operational risk; however any such efforts would be coordinated efforts with the Cybersecurity Task Force.

ORSA - As of July, 35 states have enacted the *Risk Management and Own Risk and Solvency Assessment Model Act* and 13 states have pending legislation. The results of the 2014 ORSA pilot project indicate that operational risk is identified as a key risk by all companies participating in the pilot, but there is varying selection of event types falling under the heading of "operational risk." Additionally, operational risk seems to be a catch-all for all other risks that do not fall under the specific categories reported in the ORSA, such as market risk, underwriting risk, liquidity risk, credit risk and emerging risk.

Ownership of the risk appears to be with the chief operating officer but specific internal controls appear to be a work in progress. Only two companies were able to quantify capital charges for operational risk. The pilot indicates that there is currently no consistency with how operational risk is defined, how the exposures are quantified, how the control frameworks are developed and how the capital charges are quantified. Approximately 300 companies (both group and legal entity) are expected to file their ORSA summary reports starting this year. A trade organization representative raised a question on where the push for developing a proxy-driven operational risk charge is coming from when most jurisdictions other than Solvency II use a capital add-on approach. The subgroup will continue to discuss development of the operational risk charge and incorporate the results of current year ORSA summaries when the information becomes available.

2015 Informational-Only Filing (2015-13-O)
The informational-only operational risk charge is comprised of two components: 1) a growth risk charge, and 2) a basic operational risk charge for items other than growth risk. The basic operational risk charge will be computed in two different ways: 1) factors to premium and claim liability reserve proxies will be applied, and the charge that is the greater of those two would be the charge used for the basic operational risk; and 2) a capital add-on approach. In June, the subgroup exposed the operational risk factor proposal for public comment which comprises the growth risk factors and basic operational risk factors. The growth risk factors derived based on preliminary analysis of 2013 and 2014 data are P/C 17.5%, health 2% and life 5%. The basic operational risk factors were based on analysis of 2012–2014 data using a 3% capital add-on factor for all formulas and roughly duplicating that capital level to establish factors on either net written premiums or net reserve liabilities; factors are for P/C, a 2% factor for both premiums and reserves; for health, 0.5% for premiums and 3.5% for reserves; and for life, 1.2% for premiums and 0.3% for life and annuity reserves.

Six comment letters were received and discussed. A trade organization asked for the health premium basic proxy factor to be changed from 0.5% to 0.3% to be consistent with the comparative analysis provided for the 3% capital add-on approach. A life trade organization proposed that the subgroup not go forward with the informational factors for 2015 because basic operational risks are already included in the C-4 factor. Commenters also questioned why initial factors are necessary as opposed to background testing of factors; commenters noted that when factors are proposed regardless of whether or not they are considered as informational-only, there seems to be a perception that they are the target factors. The NAIC staff noted that the process will allow companies to assess specific impact and provide a transparent way to collect potential enhancements or revisions to the initial methodology and factors from both regulators and the industry before any decisions are made.

Following the discussion, the subgroup adopted the proposal with edits to lower the health premium basic factor from 0.5% to 0.3%, add clarifying language that negative growth will not reduce RBC (i.e. the growth charge is capped at zero), and add clarifying language that both the methodologies and factors are informational-only. These changes, along with the rest of the proposal discussed above, are effective for 2015 RBC filings.

Next Meeting
The subgroup will hold a conference call September 14 and is scheduled to hear an oral report from the Operational Risk Consortium.

Property/Casualty Risk-Based Capital Working Group

The working group met by conference call on April 22, June 19 and July 8 and in Chicago to discuss the following projects.

2014 RBC Results
The working group discussed the results of the 2014 P/C RBC filings noting consistency with prior years. As in prior years, risk retention groups made up a sizable portion (1/3) of the companies that were flagged by the trend test or in an action level, likely due to their use of a different accounting treatment (U.S. GAAP). Of approximately 2,500 companies, 74 and 57 companies triggered an action level event

with and without considering the catastrophe risk charge, respectively. The working group discussed ways to further analyze the data and noted it will continue to explore data analysis options without compromising confidentiality of data.

Underwriting Risk Factors (2015-11-P)
The working group discussed and exposed a proposal that provides routine annual updates to the industry underwriting reserves and premium factors in the RBC formula. No comments were received and the working group adopted the proposal on June 19.

RBC for Affiliate Investments
In June, the working group discussed a proposed referral to the Capital Adequacy Task Force highlighting issues relating to affiliated investment risk. It was noted that several categories of affiliated investment risk are not straightforward nor are they easy to validate. An example is an investment affiliate entity that exists solely to invest funds of the parent company whereby the RBC charge for the entity is based on the underlying assets held by the investment affiliate. Investment affiliates do not file RBC reports and therefore, regulators are not able to verify the accuracy of data filed. Since the affiliated investment risk is an element in all the RBC formulas, the working group recommended that the task force undertake or designate a subgroup to ensure that the formulas are aligned with the original intent of RBC (i.e., straight forward for filers, easily validated for regulators, and consistent across all blanks unless valid explanations exist for differences). The referral was discussed by the task force in Chicago; see that discussion above.

The working group also discussed its own proposed solution to the investment subsidiary issue. At the Spring National Meeting a fixed factor approach for calculating RBC for investment subsidiaries (2014-29-P) was not adopted due to concerns that a fixed factor results in less accurate reporting. The working group discussed another option to consider additional worksheets to list all the investments owned by the subsidiaries. A marked-up version of the additional worksheets was provided and interested parties agreed to provide comments even though the changes to PR004 are not being exposed. The working group will continue its discussion in upcoming calls.

The working group plans to discuss outstanding projects in its next conference call on September 30.

Catastrophe Risk Subgroup

The subgroup met by conference call on April 22 and June 19, held an e-vote in May and met at the Summer National Meeting to discuss its projects.

Attestation Revision (2014-40-CR)
The subgroup discussed a previously exposed proposal to add a question to page PR002 for companies to disclose which of the methodologies was used to sort the net and gross probable maximum losses so regulators can collect data on how companies are deriving their modeled catastrophe losses. No comments were received and the subgroup adopted the proposal with minor modifications.

Catastrophe Risk Charge Exemption (2014-37-CR)
The subgroup discussed a previously adopted proposal that exempts companies from completing PR026 by providing interrogatories to determine whether there is substantive earthquake and hurricane risk exposure based on minimum coverage exposure and surplus percentages of property insured value in catastrophe-prone areas. On April 22, the subgroup discussed possible thresholds for exemption noting that having a low threshold percentage and analyzing the 2015 data when it becomes available in March 2016 would be an alternative. The subgroup re-exposed the proposal after adding three lines of businesses for purposes of the exemption (reinsurance–non-proportional assumed property, reinsurance–non-proportional assumed liability and workers compensation). On June 19, the subgroup discussed the proposed criteria noting that a company may be exempt if it has no or minimum exposure in any of the following circumstances: 1) satisfies 0% net exposure, 2) has a ratio of property insured value to policyholder surplus of less than 50%, or 3) writes property insured value that includes hurricane and/or earthquake coverage in catastrophe-prone areas representing less than 10% of policyholder surplus. The subgroup also heard a recommendation from the AAA to explicitly define the states in the New Madrid Seismic Zone and the subgroup identified these states as Arkansas, Illinois, Kentucky, Mississippi, Missouri and Tennessee. All changes to the proposal were adopted by the subgroup.

Catastrophe Risk Charge (2015-10-CR)
Following the discussion at the Spring National Meeting in which the subgroup agreed that the contingent credit risk charge should be calculated in a manner consistent with the way the company internally evaluates and manages its modeled net catastrophe risk, the subgroup discussed a proposal to introduce factors which convert modeled

catastrophe losses from Occurrence Exceedance Probability (OEP) basis to Aggregate Exceedance Probability (AEP) basis for R6 and R7. The subgroup noted that there are situations whereby companies adopt the OEP basis when modeling catastrophe losses. The revisions would allow companies to compute the catastrophe RBC charge on an AEP basis using catastrophe modeling results which are on an OEP basis. An interested party raised concern that the use of an arbitrary load to convert an AEP would lead to inaccurate and misleading results. Following the discussion, the subgroup agreed to keep the OEP factors to 1 for 2015 reporting with plans to refine the factors at a later date.

Ex-Cat Factors (2015-12-CR)
On May 20, the subgroup exposed proposed revisions to Line 1 and Line 4 ex-cat factors for PR018A; new factors were determined based on additional data. No comments were received. On June 19, the subgroup adopted the proposal.

Company Models
In Chicago, the subgroup discussed an interested party recommendation to allow companies to use their own loss projection models in addition the five approved commercially available models. This led to a broader discussion around the use of internally developed models or other models that have not been independently reviewed. The subgroup heard concerns from regulators regarding the lack of transparency with these types of models which led to a discussion on how to balance regulator concerns with allowing companies to model hurricane and earthquake losses consistent with their own internal risk management processes. The subgroup will continue to explore the possibility of expanding the number of allowable models.

Other Catastrophe Risks
Consistent with its charge to continue to refine the catastrophe risk charges, the subgroup noted that it has always been its intent to determine if risk charges for any other catastrophic perils such as tornado, wildfire, and terrorism should be added to the P/C RBC formula. Interested parties noted that terrorism and cyber risks may not have enough data to be appropriately modeled and included in the RBC formula. The subgroup plans to continue its discussion in future meetings.

The subgroup plans to discuss outstanding issues in its next conference call on September 30.

Health Risk-Based Capital Working Group

The working group met by conference call on April 21 and met in Chicago to discuss the following issues.

2015 Underwriting Risk Instructions (2015-06-H)
The working group discussed a previously exposed proposal to correct an issue whereby the health RBC instructions do not address where a company should report life and P/C premiums in the health RBC formula. The instructions currently reference Column 6 on XR012 and XR012A "Other Health Coverages." The proposal would delete the reference to "Health" in the heading and add proposed language to clearly identify that life and P/C business should be included in Column 6 – Other. The working group heard comments from a trade organization that using the existing column makes sense; however companies writing other premiums classified as Column 6 in the health formula would receive a 13% factor, while in other formulas, a higher factor may be applied to those same lines of business. The chair agreed with the comment, but suggested that the working group move forward with the current proposal. A new proposal for 2016 will be drafted to address this issue since the changes would require a structural change to the formula. Following the discussion, the working group adopted the proposal.

2016 Underwriting Risk Instructions (2015-14-H)
To address comments related to previous proposal (2015-06-H), NAIC staff drafted revisions to add a new column to separate other non-health business from other health business which is consistent with the reporting in the Annual Statement Analysis of Operations page. The working group discussed the proposal in Chicago and exposed it for public comment through September 17.

Medicaid Pass-Through Payments Survey
The working group continued its discussion from the Spring National Meeting in a conference call on April 21. The chair confirmed that Medicaid pass-through payments are not considered an underwriting risk and asked the working group if there should be further clarification to the RBC instructions to include these payments under business risk rather than underwriting risk. The chair further noted that consideration could be given to revising the instructions for page XR012 to exclude pass-through payments from premium for RBC purposes, similar to administrative services only and administrative services contract business, and add new lines to page XR021 under business risk for Medicaid pass-through payments. The chair noted that after

discussions with NAIC staff, it was determined that the payments could be accounted for as uninsured plans under SSAP 47. The issue for RBC reporting is when a company has a significant increase in payments and reports them as premiums which impacts its RBC through the underwriting risk charge when there is no underwriting risk involved. The subgroup decided it will gather more information and will discuss in more detail on a future call.

Asset Risk in the RBC Formula
In Chicago, the working group continued its discussion on the impact of the recommended changes to the life RBC formula by the Investment Risk-Based Capital Working Group which may affect the health formula. It was noted that the factors and granularity that are being proposed for the life formula may not be applicable to the health formula because of differences in the way assets are held and used in the health line of business. Refer to the Investment Risk-Based Capital Working Group summary for additional details. It was noted that the NAIC staff has identified several reports outlining the differences between each of the formulas and is seeking volunteers from the working group and industry to review the reports through an informal technical group. During its September 2 conference call, the working group agreed to form an ad hoc group to research and identify the rational for the different treatment and impact of asset risk on the health RBC formula compared to the life RBC formula; anyone interested is to respond by September 9.

Dual-Eligible Plans in RBC Reporting
The working group discussed dual-eligible plans, which are plans for individuals who, at any given time, are either on a Medicare or Medicaid plan and can go in and out of either plan periodically. A person can qualify for Medicare and Medicaid at the same time and the plans are designed to coordinate care better and money is received from both Medicare and Medicaid. It was noted that some carriers are recording all proceeds into either the Medicare or the Medicaid “bucket” when they should have been split between the two lines of business. Currently, there are not clear instructions in the annual financial statement on how to report this.

After analyzing the impact to RBC, it was found that it would not likely impact the current RBC formula; however, if different factors are developed for Medicare or Medicaid, then it would likely have an impact. Additionally, for states that charge premium tax for Medicaid and not for Medicare such as Minnesota, the effect is that carriers that included all premiums in the Medicaid bucket were taxed while carriers that included all premiums in the Medicare bucket were not taxed. Thus, a question was raised on whether the instructions need to be clarified for these dual-eligible plans. The AAA noted that an insurer calculating a premium deficiency reserve would likely consider this dual product its own line of business separate and distinct from traditional Medicaid and separate from a Medicare Advantage product. The NAIC staff noted that there is a blanks proposal in process to pull out Medicare Advantage and Medicare Part D because they are subject to medical loss ratio requirements. The working group will continue to study this issue and directed NAIC staff to work on a proposal.

Valuation of Securities Task Force

The task force held five interim conference calls and met in Chicago, taking the following actions:

RMBS & CMBS Modeling Vendor
The NAIC Structured Securities Group announced that BlackRock Solutions has been selected as the exclusive vendor to perform financial modeling of RMBS and CMBS for the next three years. The SSG is working with BlackRock to evaluate the potential impact of the vendor change for RMBS, which have been modeled by PIMCO since 2009. The analysis will be shared with the industry to allow insurers to assess the potential impact to carrying values and RBC requirements. Consistent with prior years, the task force plans to conduct a series of public calls to discuss macro-economic factors and scenarios to be used in the 2015 financial modeling.

Reporting Exceptions
Based on its review of 2014 Schedule D filings, the SVO reported it appears the industry continues to inappropriately reflect a significant number of securities as filing-exempt. The SVO has identified 4,889 securities, with total book adjusted carrying value of $116.8 billion, which initially appear to be subject to filing requirements. These exceptions appear on the state examiner Jump-Start reports, and are routinely investigated during the financial examination process. With the growing volume of exceptions, the SVO is considering possible options to reduce the number of exceptions appearing on the Jump-Start reports. The task force requested that the SVO provide state-specific exception reports to state examiners and continue working with the industry to develop a solution.

Derivative Instrument Model Regulation
In response to a charge from the Financial Condition Committee, the task force is considering whether the *Derivative Instruments Model Regulation* should be retained, amended, converted to a guideline or

archived. While the model regulation has had low adoption rates among states, the NAIC Investment Analysis Office (IAO) initially concluded that derivative regulation is an important issue that the NAIC should continue to have a position on. The task force held lengthy public educational sessions in June and July with industry experts on derivatives including broker dealers, derivative legal experts, the SEC and consultants to understand how the derivatives market and related regulation have changed since the Model was last revised in 2009. The IAO is currently working with the ACLI to prepare a summary report of the education sessions; in Chicago, a preliminary draft of the report was shared with the task force and interested parties, but it was not formally exposed.

The key takeaway from these sessions is that the derivatives market, which was essentially unregulated in 2007, is now "comprehensively regulated." Federal regulation directly and indirectly impacts derivative positions of insurers. Once the IAO has completed its summary report, it expects to revise its initial recommendations regarding retention of the Model.

Filing Process Modernization

The SVO is evaluating its computer system needs and related processes to improve its ability to provide high-quality and timely credit and valuation assessments to the industry. This undertaking has prompted the need to revisit the filing process rules defined in the IAO Purposes and Procedures Manual, as the IAO intends to build the rules into new systems. The current filing rules, which were developed approximately twenty years ago, include substantial requirements for paper documentation in the filing process. The current rules place stress on analysts at year-end to produce quick results, while underutilizing SVO resources in the first half of the year. The SVO recommends that the rules be reviewed and updated for a digital-based framework to enable better management of the workload throughout the year.

In Chicago, the SVO reported that it has held discussions with the ACLI, the North American Securities Valuation Association and the Private Placement Investors Association; the groups are working together to address mutual concerns and work towards a consensus proposal.

New CRP

The task force received a letter from HR Ratings de Mexico, S.A. de C.V. requesting approval as an NAIC Credit Rating Provider. HR Ratings was established in 2007 and is currently the largest rating agency headquartered in Latin America and has been registered as an NRSRO with the SEC since November 2012. The task force directed SVO staff to enter into negotiations and finalize an agreement recognizing HR Ratings as a CRP.

NAIC Bank List

The task force has been considering whether the current Bank List contained in the P&P Manual should be expanded to include financial institutions more broadly to be consistent with the terminology used in the Credit for Reinsurance Models. In Chicago, the SVO reported that its research indicates that the default risk on LOCs issued by non-bank financial institutions is not significantly greater than that of banks; further, NRSROs apply the same criteria and methodologies to develop credit ratings for both bank and non-bank financial institutions. The SVO expects to submit a formal proposal to expand the Bank List to a List of Qualified U.S. Financial Institutions in advance of the Fall National Meeting.

Securities Listed by SVO

The task force has been working with the Reinsurance Task Force to develop a consistent interpretation of the phrase "securities listed by the Securities Valuation Office," as that term is used in both the Credit for Reinsurance Models to establish investments which are acceptable forms of collateral for reinsurance obligations. In Chicago, the Reinsurance Task Force voted to expand the collateral definition and delineate between an investment security, and a "regulatory transaction," or a funding solution to a company/state-specific regulatory issue. This change will allow investment securities to be listed as acceptable collateral, but will exclude regulatory transactions. The VOS Task Force is expected to consider this proposed amendments to the P&P Manual on an upcoming conference call.

5*/6* Designation Procedures

As a result of the recent addition of Part Seven, NAIC SSG, to the P&P Manual, there has been confusion during the 2014 filing process regarding the meaning of "structured securities." Specifically, some insurers concluded that the special reporting provisions referred to as 5*/6* are applicable to structured finance securitizations. The SVO staff presented a report which explained that the 5*/6* process is intended to apply only to a group of complex corporate securities, and not to securitizations. At the Spring National Meeting, the task force exposed an SVO proposal to amend the P&P Manual to clarify that the 5*/6* process does not apply to securitizations.

On its June 2 conference call, the task force discussed a recommendation from ACLI to add an interrogatory into the annual statement blank for the

insurer to certify that all the securities in the annual statement with the 5* designation are current as to principal and interest. The interrogatory would clearly state that the SVO is not responsible for the 5*/6* rating. SVO staff acknowledged that the 5*/6* designations process does not represent an "analytical process" and agreed the SVO could be removed from administrative oversight of this process. Accordingly, the SVO withdrew its proposal to amend the P&P Manual and support the industry recommended interrogatory. The task force referred the matter to the SAP Working Group to confirm that removing the SVO from the certification process and replacing it with an interrogatory in the annual statement is not inconsistent with current statutory accounting and reporting guidance.

UK GAAP Considerations
The P&P Manual currently permits the submission of financial statements prepared in accordance with UK national GAAP without reconciliation to U.S. GAAP for SVO analysis purposes. However, changes adopted to UK GAAP, effective in 2015, may require an amendment to instructions in the P&P Manual to preserve the U.S. GAAP reconciliation exemption. The SVO continues to work with the ACLI to study the impact of the recent changes in UK GAAP. Based on their analysis thus far, most of the changes have been made in order to align with IFRS and to eliminate redundant disclosures.

The SVO is also studying whether to support a proposal from ACLI that financial statements prepared in accordance with Dutch GAAP and Italian GAAP can be filed with the SVO for analysis purposes without reconciliation to U.S. GAAP.

Non-Recourse Loans
At the Spring National Meeting, the SVO reported that it had assessed the credit quality and provided NAIC designations for numerous non-recourse notes in error. The issuer of non-recourse notes has no legal obligation to repay the notes as the loans are made on the basis of charitable criteria; thus their viability as a financial asset is questionable. As a result, the SVO concluded that the P&P Manual does not grant the SVO the authority to assess these loans. The SVO also observed that non-recourse notes may not meet the definition of an admitted asset under statutory accounting principles. The SVO consulted with NAIC statutory accounting staff who confirmed that the concern was justified. On its June 2 conference call, the task force considered comment letters received on the issue from the ACLI and Anderson Insights. Following extensive discussion of the interplay between various statutory accounting principles and the P&P Manual, that task force referred further consideration of the statutory accounting treatment to the SAP Working Group.

Group Solvency Issues Working Group

The working group met by conference call on July 10 and at the Summer National Meeting and discussed the following projects.

Own Risk Solvency Assessment Pilot Project
The working group adopted the 2014/2015 ORSA pilot report. The summary report included information from 27 companies and 26 states that participated in the pilot. The report highlights three key observations: 1) the reports were generally in compliance with the requirements, 2) the reports reflected a maturity of the risk management function; and 3) the life industry has more developed ORSA processes than P/C and health companies. The chair described the project as a "tremendous success," citing the improvement of the reports over the previous years, which was largely based on the collaboration of industry and regulators.

Changes to the Financial Analysis Handbook
Following the discussion at the Spring National Meeting in which the working group discussed potential changes to the supervisory college section of the Financial Analysis Handbook, the staff proposed additional changes that were discussed on its July 10 conference call. The changes are intended to provide state regulators with a consistent approach on leading supervisory colleges while incorporating best practices from state and international regulators. Interested parties had recommended language requiring states to rely on the group-wide supervisor. The working group did not incorporate this recommendation, noting there have been situations where international group-wide supervisors cannot or will not provide the lead state with more information. The working group believed it was important to maintain flexibility as supervisors around the world continue to grow more comfortable sharing information with each other. At the request of an interested party, the working group agreed to reconsider the issue of relying on the group-wide supervisor after regulators have had more experience with supervisory colleges. The proposed changes discussed during the July 10 conference call were adopted at the Summer National Meeting.

International Insurance Relations Committee

IAIS Stakeholder Procedures
At its meeting in Chicago, the committee heard from a representative from the IAIS who emphasized the IAIS's commitment to re-evaluate how it engages

stakeholders. The NAIC and many interested parties have been critical of the recent change in approach by IAIS to limit the meetings to which stakeholders could participate; many have expressed the desire for more transparency and interaction. The representative noted that the IAIS is considering how to most effectively transition from the current observer approach, which some have characterized as "pay to play," to broader stakeholder involvement. Earlier this year, the IAIS held stakeholder meetings on capital and field testing, and feedback was also sought following the IAIS 2015 mid-year committee meetings in Macau, China. The IAIS representative acknowledged that stakeholder participation at the Macau meetings was not optimal, and improvements will be made for future events. Another stakeholder meeting is planned for October 5 in Basel, Switzerland, to discuss revisions to the Insurance Core Principles, comments received on consultation papers, and progress on capital and ComFrame.

Financial Sector Assessment Program (FSAP)

The committee discussed the results of the International Monetary Fund's FSAP of the U.S. regulatory regime, which are largely positive. The FSAP report acknowledged broad compliance of the U.S. insurance system with the IAIS Insurance Core Principles with 21 of the 26 ICPs being considered either "observed" or "largely observed." The report recognized that a number of state and federal reforms are pending and will take time to be fully implemented. Although there were no significant findings, the report did provide some constructive observations and recommendations. The IRR Committee noted that state regulators disagree with some of the recommendations, noting that IMF appears to favor one particular approach to compliance with an ICP versus a more objective, outcomes-based approach of observance.

The FSAP also assessed the U.S. insurance system's resolution, stress testing and systematic risk oversight against the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions, observing that FSB's guidance is not specific enough to insurance because the attributes are bank-centric. The FSAP report acknowledges that, since the IMF's last assessment: 1) the U.S. insurance supervision framework has been strengthened; 2) state regulators have taken steps to improve group and international supervision; and 3) the NAIC plays an important role in promoting consistency across state regulation. Nevertheless, the IMF calls for "an insurance regulatory body with nationwide remit" to "deliver enhancements and greater regulatory and supervisory consistency."

The NAIC has noted that it is unclear how the IMF believes creating another regulator and new federal bureaucracy would improve the current U.S. system of insurance regulation and that state regulators strongly disagree with this recommendation as the state-based system has proven its strength and has served consumers and the U.S. economy well for decades. The report also makes several other recommendations, including 1) developing and implementing group supervision and group-level capital requirements for insurance companies, and 2) changing the valuation standard to reflect the IMF's view of the economics of insurance products. The IRR Committee believes these areas are already being addressed within the NAIC.

The NAIC will continue to review the relevant recommendations of the FSAP reports to determine if there are any points that should be considered by NAIC committees. However, the committee acknowledged that it is premature to conclude on any specific recommendations that might be considered. A specific review process has not yet been defined; however, input will be solicited from the industry and other interested parties.

U.S./EU Insurance Project

The U.S./EU Insurance Project continues to progress with significant collaboration between U.S. and European regulators. An update on the project is expected to be provided at the NAIC Fall National Meeting. The working group and interested parties again raised concerns regarding persistent uncertainty surrounding the treatment of U.S. insurers by EU regulators under Solvency II. Specifically, the EU has not concluded on U.S. equivalence for group supervision and reinsurance. Thirty-two states, representing 66% of annual written premium, have now adopted the revised *NAIC Credit for Reinsurance Model Act*. The model act allows for review of an international reinsurer's financial condition and the strength of its regulatory environment to determine if reduced collateral requirements should be permitted. Although the pervasive adoption of the model act represents progress on the reinsurance forefront, the Treasury Department and the Office of the United States Trade Representative are considering advancing a federal covered agreement to address both reinsurance requirements and group supervision. The NAIC continues to oppose the federal covered agreement proposal because it could pre-empt state law and undermine the current regulatory structure in the U.S.

ComFrame Development and Analysis Working Group

The ComFrame Development and Analysis Working Group met via conference call on July 30 and at the Summer National Meeting.

ComFrame
The IAIS continues to push forward with field testing of its Common Framework for the Supervision of Internationally Active Insurance Groups. There has been significant progress in the analysis of qualitative responses received on corporate governance and enterprise risk management standards. Additionally, submissions of quantitative data appear to be on track with the last phase due by September 4 at which point full analysis will begin.

International Capital Standard
The working group heard that field testing of International Capital Standards for Internationally Active Insurance Groups is ongoing and that the standard will continue to be revised based upon any findings through discussion amongst the IAIS. As previously planned the Basic Capital Requirement and Higher Loss Absorbency requirement continue to evolve with intended implementation in 2019. The IAIS's HLA consultation draft issued on June 25 had a comment deadline of August 21.

The working group has established interim and ultimate goals for ICS. The ultimate goal is a single ICS that introduces common methodology, and achieves comparable outcomes across jurisdictions. The first phase is a standard that will identify two valuation approaches and a standard method for calculating the capital requirement while the second stage will focus on improved comparability compared to phase one. The immediate next steps will be the next consultation paper, which will be released in the summer of 2016.

Development of a Domestic Group Capital Standard
The working group discussed comment letters on its U.S. Group Capital Methodology, first exposed at the 2014 Fall National Meeting. The working group emphasized that the objective of the group capital standard is to provide a quantitative measure for group risks and is not intended to represent a group capital requirement. It could be a tool for supervision of all U.S.-based groups as opposed to limited to a specific sub-group.

The working group discussed the three different proposed approaches, which are RBC aggregation, statutory consolidated filing for RBC, and GAAP consolidated filing for RBC-Plus. The RBC aggregation approach uses the RBC calculations determined at the entity level within the group structure. The statutory consolidated filing would require consolidated accounting rules within statutory accounting principles and then calculate RBC requirements based upon the standard RBC formula. Finally, the GAAP consolidated filing for RBC-Plus calculation approach uses GAAP consolidated financial results in an adjusted RBC formula.

Interested parties continue to provide significant feedback with a focus on understanding the objectives and relationship to existing regulatory requirements and measures. Multiple interested parties have specifically requested further clarification as to why the calculation is necessary. The working group believes the financial crisis provides evidence that there must be a heightened awareness of the stability of groups at a broader level. Furthermore, states are strongly considering adopting group authorities, which could be supported by a group capital calculation. Interested parties shared that they are highly interested in the development of this topic and also emphasized that the costs and benefits of each approach must be carefully considered. In particular, interested parties noted that leveraging existing data, which is a key advantage of the RBC aggregation approach, is critical. The next step subsequent to a deliberative NAIC process with multiple rounds of comments would be the development process under the supervision of the Financial Condition Committee.

Financial Stability Task Force

The task force chair provided an update on the recent activities of the IAIS, including the results of the latest data collection effort from potential global systemically important insurers (G-SII). The chair observed that the quality of information provided by the 50 insurers within the scope of the review has improved; the IAIS continues to analyze results. The IAIS is expected to conclude in September as to which entities should be designated as G-SII; it will provide its recommendations to the Financial Stability Board. The methodology to identify a G-SII is under review to improve the relevance of the designation; a revised methodology will likely be applied next year.

The task force chair reported that non-bank, non-insurance (NBNI) entities are also being considered for identification as systemically important financial institutions (SIFIs) by the FSB, most notably, investment funds managed for third parties by an asset manager subsidiary/affiliate of an insurer, mortgage insurers, and financial guaranty insurers. The FSB's identification of these NBNI global SIFIs

continues to be reviewed and requires a high level of scrutiny based upon the diversity of entities that fit within the definition of NBNI. The FSB does not expect to finalize its methodology for identification of NBNIs until the first quarter of 2016.

The task force discussed the joint responsibility and importance of continued collaboration between the Federal Reserve Board and state insurance regulators to monitor and regulate systemic risk within the financial system.

FSOC Report
The task force discussed the Financial Stability Oversight Council annual report released in May, highlighting that the industry's economic environment continues to improve, but is being challenged by low interest rates, cybersecurity and risks associated with complex captive reinsurance. The task force also discussed the FSOC's process to designate non-banks as SIFIs, which has changed based upon feedback from a variety of interested parties.

Interest Rate Environment
An NAIC actuary provided a report to the task force on the impact of the low interest rate environment to the life insurance industry. Low interest rates continue to erode profitability, which is a persistent risk as investment portfolios continue to turnover. The risk varies across the industry based on product mix and underlying product features. Overall, life insurers continue to develop strategies to respond to the risks associated with lower interest rates by modifying product features, re-evaluating the strategic deployment of assets, and diversification into other types of businesses.

Reinsurance Task Force

At the Summer National Meeting the task force highlighted that its goal will be completion of the new *XXX/AXXX Captive Reinsurance Model Regulation* by the end of 2015; they also discussed the following projects.

Update from the Reinsurance Financial Analysis Working Group (ReFAWG)
Having adopted the Uniform Checklist for Certified Reinsurers in December 2014, the working group met via regulator-to-regulator conference calls in June and July 2015 to discuss suggested wording changes, primarily relating to material past due reinsurance obligations, within the "Disputed and/or Overdue Reinsurance Claims/Business Practices" section of the Checklist. The Checklist is used to ensure a reinsurer's application for certification is complete. The edits were made to address industry concerns with the Checklist, and broadly loosened the thresholds that would require additional reporting requirements. The proposed amendments were exposed for comment until September 15.

The concept of passporting, or multi-state recognition of a reinsurer certification, was discussed during the same regulator-to-regulator calls, as well as at the Summer National Meeting. A reinsurer may apply for passporting in other states by submitting an application to ReFAWG, acting on behalf of the NAIC, to facilitate the passporting process. ReFAWG will make the recommendation to the NAIC, but ultimately each state has discretion and may defer their certification. The chair of the working group noted that they have approved three renewals, as well as two of three certified reinsurers for passporting, bringing the total to 28. The chair also stated that he does not believe there is a need for a covered agreement (a concept that received considerable discussion during the Spring National Meeting), and the NAIC has demonstrated this by nearly every state passing the revised Credit for Reinsurance Models. The Passporting Public Memorandum was also exposed until September 15. The task force hopes to adopt the changes to the Checklist and Passporting document by the Fall National Meeting.

XXX/AXXX Captive Reinsurance Regulation Drafting Group
The task force had a lengthy discussion of the progress of the drafting group's first draft of the *XXX/AXXX Model Regulation*, which it hopes to finalize by year end. The proposed model will establish reinsurance requirements for transactions subject to AG 48.

The group discussed four options to determine to what extent the credit for reinsurance should be reduced if there is a shortfall relative to the Primary or Other Security collateral, as outlined below:

1. "All or nothing" – credit for reinsurance would only be allowed if the entity maintains primary security holdings equal to the principal-based reserve.
2. Dollar for dollar reduction – credit for reinsurance is reduced dollar for dollar by the shortfall between the entity's primary security holdings and the required level per PBR.
3. Percentage reduction – credit for reinsurance is reduced by a proportional percentage of the shortfall between the entity's primary security holdings and the required level per PBR.
4. Primary Security limitation – credit for reinsurance is based on the amount of the entity's primary security holdings.

On a July conference call after a lengthy discussion, the drafting group ultimately voted for option 1, but the vote was not unanimous. The drafting group leaned toward that option partially based on the premise that it is a privilege to finance part of a company's reserves, and therefore should only be granted when there is full compliance with the requirement. Separate from this decision on a credit for reinsurance consequence option, there is an RBC charge that is governed by the Life RBC Working Group, which the drafting group also noted as a consideration for the group to consider when deciding on an option.

During the Summer National Meeting, the task force continued this discussion, and although the drafting group ultimately voted on option 1, since the vote was not unanimous, they asked the task force to consider all four options. Commissioner Torti noted that out of the four options, he would support option 1 as well, being that the aim is to promote companies to comply with AG 48, not to have companies weigh the option of compliance verse non-compliance.

An ACLI representative pointed out that AG 48 already has two remediation options: either adding additional collateral for any shortfall, or a dollar for dollar reduction. He noted that if an all or nothing option is finalized, it may incentivize companies to remove all collateral in the event of an insignificant shortfall.

The task force then voted to expose for comment the key discussion topics memorandum, the *XXX/AXXX Credit for Reinsurance Model Regulation* draft and revisions to the *Credit for Reinsurance Model Law* until September 30.

Reinsurance Modernization Implementation
The task force received an update on the adoption of the revised Credit for Reinsurance Models by the states, noting that 32 states have passed the Model Regulation, which represents more than two-thirds of U.S. direct premium. Nineteen states have also adopted the Model Law.

Variable Annuity Issues Working Group

This new working group was formed at the Spring National Meeting with a charge to "oversee the NAIC's efforts to study and address, as appropriate, regulatory issues resulting in variable annuity captive reinsurance transactions." The working group is composed of domiciliary regulators of insurers who have formed VA captives and include the following states: Iowa (chair), California, Connecticut, Michigan, Missouri, Nebraska, New Jersey, New York and Ohio. The working group held its first public meeting August 7 to discuss both its plans to address its charge and a proposed disclosure for year-end 2015 financial statements drafted by the ACLI (and subsequently exposed by the SAP Working Group at the Summer National Meeting).

With regard to its charge, the chair noted that variable annuity captive issues "seem to revolve around the belief from the industry that the statutory rules are too punitive on hedges and forces them to use these vehicles to avoid requiring the use of non-economic hedges to fit the statutory treatment." The working group has engaged a consultant to help understand the issues and develop solutions and hopes to have a solution in place by January 1, 2017.

The working group then had a detailed discussion of the proposed disclosure, which would amend SSAP 61R, Life and Health Reinsurance, and would require the following information for reinsurance of VA contracts with affiliated captive reinsurers:

- Types of benefits being reinsured and description of the significant terms of the reinsurance agreements
- Risks retroceded to a third party and risks retained by the ceding company and its parent, subsidiaries and affiliates
- Disclosure of an "RBC-type calculation" on either a stand-alone option or consolidated option, and
- Reserve credit taken by the ceding company, and total amount and nature of collateral supporting the reserve credit.

Some regulators objected to exposure of the disclosure by the SAP Working Group without first obtaining input from the VA Issues Working Group; the chair explained this was necessary in order to meet the 2015 disclosure deadline. He noted that he views the disclosure as just the first step of the process and expanded disclosures, changes to RBC and other solutions could be implemented after 2015.

The working group held a conference call September 3 to discuss its draft comment letter to the SAP Working Group on the proposal that had been exposed for comment in Chicago. The working group recommended expanding the disclosure for additional information on the purpose of each transaction and the reserve methodologies used by the captive and how those differ from the requirements of AG 43. They also recommend that the RBC disclosure not be an option i.e. disclosure of both the stand alone and consolidated information. Finally, the working group recommended that the definition of affiliated captive reinsurer be made

consistent with that recently adopted for other captives for Schedule S reporting.

Because of the extensive revisions to the draft comment letter, including the proposal to move confidential Plan of Operations disclosures into a filing with the Financial Analysis Working Group, the working group did not adopt its comment letter for submission to the SAP Working Group. They will hold another conference call September 16 to finalize the letter.
On September 10, the working group will hold an in-person meeting interim meeting in Chicago, which will include a regulator to regulator session in the morning and an open meeting with VA insurers and other interested parties to begin discussion of possible solutions to the hedging and other identified issues.

NAIC/AICPA Working Group

Access to Audit Workpapers Best Practices
During its June 11 conference call, the chair reported that the AICPA/NAIC Task Force has been working for some time with a group of volunteer regulators and had drafted a white paper entitled *Best Practices: Insurance Regulator Access to Audit Workpapers*. The guidance includes suggestions for both CPA firms and regulators to facilitate more effective sharing of workpapers. After receiving an overview of the white paper, the working group voted to adopt the *Best Practices* document which has posted to both the NAIC and AIPCA's websites.

Blanks Working Group

The working group held conference calls on June 30, July 15 and August 5, adopting twenty blanks proposals as final. The adopted proposals included three proposals related to the Supplemental Health Care Exhibit which were exposed for public comment via an email-vote of the working group on May 22. The more significant proposals, effective for 2015 annual statement reporting unless otherwise indicated, include:

- Modifying the Supplemental Health Care Exhibit and instructions to eliminate the Aggregate 2% Rule Column for Parts 1 and 2 and replace it with a column to capture Medicare Advantage Part C Plans and Medicare Part D Stand Alone Plans, which are no longer excluded by statute (2015-02BWG).

- Moving the definitions for all property and casualty lines of business to the appendix rather than defining them within the instructions for specific schedules. It would also add definitions for lines of business included in the Property Product Matrix but not currently included in the property instructions (2015-03BWG).

- Revising instructions to clarify the reporting of health care receivables in the Underwriting and Investment Expense Exhibit (2015-05BWG).

- Modifying the instructions for Schedule A, Part 1 to reflect the reporting of real estate owned by an LLC on Schedule A if it meets the requirements set forth in SSAP 40R (2015-07BWG).

- Modifying the Cash Flow instructions to reflect the inclusion of only cash transactions, reflecting changes adopted to SSAP 69 (2015-08BWG).

- Adding a new supplement to collect data on cybersecurity insurance coverage to assist the Cybersecurity Task Force (2015-13BWG).

- Modifying instructions to Schedule D to enable additional security identifiers to be included in the electronic only version. This will assist the SVO in locating more securities in its various data feeds (2015-14BWG).

- Separating the Supplemental XXX/AXXX Reinsurance Exhibit, Part 2 into two new parts: Part 2A (Grandfathered or Special Exemption; and Part 2B, (Non-Grandfathered) (2015-18BWG).

- Making reference to the medical loss ratio cautionary statement posted to the working group's web page in the header of the Supplemental Health Care Exhibit (2015-19BWG).

- Clarifying instructions to the Supplemental Health Care Exhibit to specify how retrospectively rated contracts should be reported (2015-20BWG).

- A new table was also added to the SHCE, Part 1 to capture 3R's receivables, payables and receipts by state for individual and small group plans (2015-21BWG).

In addition to the three SHCE proposals exposed via e-vote, three other proposals were exposed for public comment following the Spring National Meeting. Consideration of these proposal continued through the Summer National Meeting, with the working group taking the following actions:

- Adopted a modification to the Supplemental Exhibits and Schedules Interrogatories

regarding filing the communication of internal control related matters noted in an audit to clarify the filing as being regulator-only, non-public and to be filed electronically with the NAIC (2015-22BWG).

- Adopted additional instructions to include the Affordable Care Act (ACA) Section 9010 fee as a write-in for special surplus in accordance with SSAP 106 (2015-23BWG).
- A proposal from the Terrorism Insurance Implementation Working Group to add a new Terrorism Risk Insurance Supplement (2015-24BWG) was adopted by the working group; however, the supplement was subsequently rejected by the APP Task Force. At the Financial Condition Committee meeting in Chicago, the chair announced that a data call of companies will be organized to obtain the data needed to comply with the Terrorism Risk Insurance Act of 2015.

The working group deferred consideration of a previously exposed proposal to include a reinsurance supplement detailing certain information that is aggregated on Schedule F (2015-16BWG), noting that the SAP Working Group is continuing to work on this item. No new blanks proposals were discussed or exposed at the Summer National Meeting.

Investment Reporting Subgroup
Following a seven month hiatus, pending the SAP Working Group's consideration of items to be reported on Schedule BA within the larger investment classification project, the subgroup held a conference call on July 21. While SAPWG has not completed its consideration of Schedule BA, the subgroup now plans to revisit items on its issue list which are not in conflict with the investment classification project. These include analyzing the usage of Schedule D description columns, the accuracy of collateral types and bond characteristics being reported, and a recent proposal by interested parties to modify the instructions for Schedule D to identify foreign investments as those are defined in the *Investment of Insurers Model Act* and those that pay in a currency other than the U.S. dollar.

Following the Summer National Meeting, the subgroup held a conference call on September 2 to consider a draft survey being developed as a mechanism for state regulators to comment on possible changes to Schedule D security description columns and foreign investment code columns. The subgroup and interested parties provided feedback on the draft survey, which will require further enhancement before being finalized. The subgroup also discussed a preliminary blanks proposal which would further clarify the reporting of short-term and cash equivalent bonds within Schedule D. The subgroup agreed to refer the draft proposal to the Blanks Working Group for formal exposure at the Fall National Meeting.

Unclaimed Life Insurance Benefits Working Group

At the Spring National Meeting the working group received approval from Executive Committee and Plenary to proceed with a model Unclaimed Life Insurance Benefits Act, which would "require all authorized insurers regulated by the state's insurance department to undertake good faith efforts, as to be specified in the Act, to locate and pay beneficiaries proceeds under unclaimed life insurance policies, annuity contracts, and retained asset accounts issued in the state or remit such proceeds as unclaimed property to the appropriate jurisdiction if the beneficiaries are unable to be located or paid." The working group did not meet in Chicago but its Unclaimed Benefits Drafting Subgroup met nine times since the Spring National Meeting to draft a proposed model. The subgroup has recently been focused on a comparison chart of lead states' draft model act and NCOIL's model act.

Life Insurance and Annuities Committee

The committee met via conference call June 4 and in Chicago and discussed the following topics.

Life Illustrations
The committee adopted the much-discussed Actuarial Guideline 49, *The Application of the Life Illustrations Model Regulation to Policies with Index-Based Interest* during its June 4 conference call. Several interested parties requested delay of implementation of Section 4 (Illustrated Scale) and Section 5 (Disciplined Current Scale) from September 1, 2015 to January 1, 2016; the committee did not agree to that change. AG 49 was subsequently adopted by Executive Committee and Plenary on June 18; see the summary of the Life Actuarial Task Force for additional discussion of the adoption of AG 49.

As a result of the discussions related to the drafting and adoption of AG 49, the committee is considering establishing a new working group that would "conduct a comprehensive review of life illustrations to determine if, and in what manner, the *Life Illustrations Model Regulation* should be revised." The committee asked for information from

stakeholders on what should be addressed with respect to illustrations.

Valuation Manual Amendments
The committee adopted all the amendments to the Valuation Manual approved by the Life Actuarial Task Force since December 2012, which was the original adoption of the VM by the full NAIC. These amendments were subsequently adopted by Executive Committee and Plenary later in June.

Proposed Revision to DOL Definition of Fiduciary
At the Summer National Meeting the committee heard a report from NAIC staff on the U.S. Department of Labor's proposed regulation to amend the definition of "fiduciary" under the federal Employee Retirement Income Security Act, which would expand the definition of fiduciary to a wider range of financial advisers to ERISA retirement plans and Individual Retirement Accounts. Staff noted that the proposed rules are "comprehensive, complex and controversial, and would make significant changes to retirement plan fiduciary rules that have been in place for almost 40 years." NAIC staff has met with the DOL to better understand how the regulation would work and how it would affect consumers and the life and annuity marketplace.

Life Actuarial Task Force

During the day and a half dedicated to the LATF meeting, the majority of the discussions related to proposed changes to the Valuation Manual. This topic and other highlights from discussions since the Spring National Meeting are summarized below.

Indexed UL Illustration Guidance
Actuarial Guideline 49, *The Application of the Life Illustrations Model Regulation to Policies with Index-Based Interest*, was adopted by LATF in April following the Spring National Meeting, and subsequently by both the Life Insurance and Annuities Committee and the Executive Committee and Plenary in June. This adoption culminated LATF's work for the last year to address the concern that a few companies are illustrating these products with extremely favorable investment returns.

The guideline defines the crediting rates to be used in the illustrations, the earned rates for the disciplined current scale, the exhibits to be included in the illustrations, and also limits the loan leverage that can be shown in an illustration. Additional consumer information (side-by-side illustrations and additional disclosures) prescribed by this guideline is intended to aid in consumer understanding of the range of results inherent in indexed products. The guidance limiting the Illustrated Scale crediting rate and the Disciplined Scale earned rate is effective for all new business and in-force life insurance illustrations on policies sold on or after September 1, 2015, and the guidance limiting the illustrated rate credited to the loan balance and requiring additional exhibits and disclosures is effective for all new business and in-force life insurance illustrations on policies sold on or after March 1, 2016.

For purposes of expediency, the adopted guideline excludes some clarifications that were discussed in the conference calls but for which timely consensus or resolution could not be reached. LATF then established the IUL Illustration Subgroup to consider post-adoption enhancements to AG 49. This subgroup is currently discussing how policyholder bonuses fit into the guideline and issues related to illustrations for policies with multiple accounts having different caps. These topics and others will be discussed on future conference calls and revisions to AG 49 may be proposed within the next year.

PBR Valuation Manual and Related Matters
Mortality-Related Valuation Manual Proposals
During the interim period LATF discussed and exposed several VM amendments which incorporate the 2017 CSO mortality table, the 2015 VBT table and related updates to the Underwriting Criteria Score Calculator. In Chicago, LATF adopted amendments referencing the previously exposed 2015 VBT table [2014 VBT projected forward to 2015] and Relative Risk tables. LATF also discussed and incorporated comments on the other amendments and re-exposed several of them for comment until September 18. LATF also discussed and exposed a new amendment allowing companies that elect the three-year PBR transition to VM-20 to elect the 2017 CSO table as the valuation mortality standard during that period.

The lengthiest discussion related to potential bases for determining PBR Margins for establishing Prudent Estimate Mortality Assumptions. The Joint Academy Life Experience Committee and SOA Preferred Mortality Oversight Group proposed an amendment that would require that credibility of company experience under PBR be determined using either the Limited Fluctuation Method by amount or Buhlmann Method by amount, and the prescribed additional mortality margins would vary based on the method used to determine the credibility of company experience. Discussion centered on pros and cons of each method, and the concern among regulators is the potential for company gaming by selecting the method yielding the lowest reserve value. No action was taken at this meeting and discussion will continue on future conference calls.

Other Valuation Manual Amendments
During the interim period LATF adopted the previously exposed amendment allowing commercial mortgages to be used in VM-20 modeling with PBR risk classes assigned based upon the relationship between NAIC commercial mortgage rating categories and current AVR and RBC factors. During the interim period LATF also submitted all adopted VM amendments since December 2, 2012, which is the date the Valuation Manual was adopted by the full NAIC membership, as a package to the Life Insurance and Annuities Committee for its consideration, in order to be available for year-end compliance with AG 38. Many of the proposed amendments are technical in nature, but also included are the small company exemption amendment, the governance process for updating the Valuation Manual and amendments related to AG 38. The small company exemption had been adopted by the Life Insurance and Annuities Committee at the Spring National Meeting, and in June all other amendments were adopted by the committee; subsequently Executive Committee and Plenary adopted the entire package on June 18.

At the Summer National Meeting, the task force adopted the previously exposed amendment which modified the treatment of the pre-tax IMR (PIMR) by removing it from the year-by-year calculations, thereby simplifying the calculation. The beginning PIMR is added to the present value result so the ending result is the same. At this meeting LATF also discussed and exposed clarifying amendments to VM-31, Reporting and Documentation Requirements, and an amendment providing an approach to reflect the impact of ceded YRT reinsurance when performing the Statutory Exclusion Ratio Test (SERT). When reinsurance is non-proportional, the SERT ratio can be dramatically different pre and post reinsurance, and the exposed amendment includes a provision for companies to demonstrate that the sensitivity of the deterministic reserve to economic scenarios is comparable pre and post reinsurance, thereby allowing the SERT to "pass" in the presence of YRT reinsurance. This amendment was exposed for comment until October 2 to allow sufficient time for impact testing; other amendments are exposed until September 18.

VM-20 Spread Tables
Under the VM-20 framework, separate spreads are provided for investment costs and default costs based on source data from vendors J.P. Morgan and Bank of America; default costs will be updated annually while investment spread costs will be updated quarterly. During the interim period LATF exposed and adopted the March 31 spread tables and also exposed spread tables updated as of June 30, 2015, including the addition of several supporting exhibits. During the Summer National Meeting LATF adopted the VM-20 spread tables as of June 30, 2015. Because PBR is not yet effective, the VM-20 spread tables currently apply only to testing under Actuarial Guideline 38.

Academy Council on Professionalism
The task force received an update from the American Academy of Actuaries Council on Professionalism and activities within the Actuarial Standards Board and the Actuarial Board for Counseling and Discipline. The Academy president reported that the PBR Standard is considered final and has been posted to the ASB website as "pending." The standard is not yet approved by the ASB and will be reviewed again closer to the PBR effective date once other related PBR documents are completed. Any substantive changes will be re-exposed for comment prior to finalizing the standard. The ASB anticipates approval of the standard just prior to the PBR effective date, anticipated to be January 1, 2017.

Work continues on the Modeling Actuarial Standard of Practice, which will have broad application in the profession. The second draft was exposed for comment through March 1 and many comment letters were received. Work is also underway on several other standards, including updates to Actuarial Standard of Practice 24, *Compliance with the NAIC Life Insurance Illustrations Model Regulation* for AG 49 and a new ASOP on the actuary's role in individual life insurance and annuity pricing.

Actuarial Guideline XXXIII (AG 33)
During the interim period LATF discussed comments on the proposed changes to AG 33, which address the incidence rates to be used in determining the greatest present value of integrated benefit streams for annuities with elective and non-elective benefits. In particular, incidence rates for other than mortality-based non-elective benefits are restricted where financial incentives exist for contractholders to forego non-elective benefits in favor of higher elective benefits. However, it is unclear how financial incentives would be determined. At this meeting additional edits were agreed to by LATF and exposed for public comment until September 18.

VM-22 Fixed Annuity PBR
LATF received a report from the VM-22 Subgroup on work related to development of PBR methodology for non-variable annuities. Several conference calls were held since the Spring National Meeting to discuss alternative approaches, and industry feedback favors modernizing the current formulaic/

deterministic method. During the interim period work progressed on review of the proposed Representative Scenario Method (RSM), which involves generating scenarios for each key risk driver and assigning probability weights to each scenario. In June the Academy Annuity Reserve Working Group completed and presented to the VM-22 Subgroup a report on the potential benefits as well as potential issues of the RSM, and in July the Kansas Field Test report on the practicality and accuracy of the RSM to right-size the modeled reserve for fixed indexed annuities with guaranteed lifetime income benefits was released to the subgroup. The Annuity Reserve Working Group will also review the Kansas Field Test report and will determine a position on the use of an RSM.

The subgroup has also identified weaknesses related to the interest rate methodology and valuation of optional benefits in the current Standard Valuation Law approach and is working on solutions. Work in this area is supported by the newly formed Academy SVL Modernization Working Group, which had a kick-off meeting in May and is focused on evaluating the SVL interest rate methodology. The ACLI has formed a dedicated team to explore ways of simplifying the calculation of optional benefits. No timeframe was provided for completion of these tasks.

Valuation Mortality Tables
During the interim period LATF held three open conference calls with members of the Academy and Society of Actuaries Joint Project Oversight Group to discuss the SOA impact study of the margins in the 2014 VBT and 2017 CSO tables on VM-20 statutory reserves, tax reserves, non-forfeiture values, and Internal Revenue Code section 7702 requirements. The preferred table structure has three preferred tables and two residual tables and the margins in the current tables cover 70-79% of claims experience from contributing companies, as required by LATF. Some LATF members were concerned that 70% coverage for male non-smokers, which is the majority of the underlying population, was too low. Conversely, the ACLI recommended that the preferred margins be reduced 25% from their current level with an offsetting increase in the residual margins. The Joint Project Oversight Group noted that the coverage percentage should not be viewed in isolation and that the 2017 mortality study has a higher level of credibility, larger number of contributing companies and broader mix of business than previous studies. At the end of the debate on the third call, the task force voted to approve the tables with the current margins. The proposed VBT and CSO tables are available for review on the NAIC website.

In Chicago, LATF also received an update from the Joint Academy Life Experience Committee and Society of Actuaries Preferred Mortality Oversight Group on the development of Guaranteed Issue, Simplified Issue and Pre-need mortality tables. The report was brief due to time constraints but a key observation of the Joint Project Oversight Group is the emerging trend of Accelerated Underwriting and the potential need to re-examine data collection under VM-51, Experience Reporting Formats.

It will be important to have both industry and regulator involvement in developing the data reporting requirements, and the Joint Oversight Group requested that a charge be assigned to develop the data requirement now so that the appropriate data is collected as the experience emerges. The LATF chair noted that VM-50 provides for an NAIC working group to be formed to be responsible for the Experience Reporting Requirements and assure that they provide for new technological, regulatory and company needs, and this may be an appropriate framework under which to evaluate this issue. No action was taken at this meeting and the discussion of the matter will continue on future conference calls.

Contingent Deferred Annuity Subgroup
The CDA Subgroup reported on activity during the interim period to address comments on the previously exposed changes to the *Standard Nonforfeiture Law for Individual Deferred Annuities* to exempt CDAs from sections 3-8 while granting Commissioners authority prospectively to require nonforfeiture benefits for CDAs. Most comments were focused on the potential for inconsistent treatment across states if authority to require nonforfeiture benefits rests with the commissioners. This is a non-technical issue outside the scope of LATF's authority, so the task force voted to send the exposed changes to the CDA Working Group for evaluation.

During the interim period the subgroup also addressed comments on the proposed changes to the *Synthetic Guaranteed Investment Contracts Model Regulation* to exclude CDAs from the scope of the model. The subgroup presented final draft changes to LATF, which the task force adopted in June. The subgroup is currently reviewing prescribed assumptions in Actuarial Guideline 43 for appropriateness relative to CDAs, as well as the need for specific references to CDAs or guaranteed living withdrawal benefits in the Financial Condition Examiners Handbook or the Financial Analysis Handbook.

Generally Recognized Expense Table
The SOA Committee on Life Insurance Company Expenses presented analysis to assist LATF in considering for adoption the recommended 2016 GRET factors. Some 338 companies were included in the base data for the analysis. The methodology used to develop the recommended factors was similar to that used to develop the 2015 factors and which reflected simplified categorization of distribution channels and a single set of updated expense seeds across all distribution channels.

For the Independent, Niche and Other distribution channels, the factors are relatively unchanged from the prior year. For the Career channel both the acquisition and maintenance expense factors are generally lower than in the prior year, while for the Direct channel the factors are generally higher. The drivers of these changes were not clear from the presentation; LATF voted to expose the 2016 GRET factors for comment until September 18. Typically GRET exposures get few if any comments, and according to a SOA survey only 25% of responding companies use the GRET, compared to 32% the prior year. SOA believes variation in GRET use is due to the relatively small sample size and different responders in the surveys.

Streamlining Actuarial Reporting
LATF received a progress report from a representative of Actuarial Resources Corporation on the project to streamline actuarial reporting to facilitate regulator access to standalone reports and increase effectiveness of actuarial reviews. Phase 1 includes review of current reports for a sample of 10 companies covering 7 different states, identify data and information points for inclusion in a streamlined report, suggest data elements to be captured in a database, and design a proposed actuarial report that facilitates electronic data capture. Phase 2 includes a voluntary field test using an actual reporting period; the field test results will be reviewed and analyzed to identify the necessary changes to the template.

At this meeting the representative provided an overview of the proposed standard reporting template and discussed data and information points identified for collection, and standardized and non-standardized reports that would be part of the submitted package, The proposed template provides for one package of files to be submitted electronically with electronic links and references to facilitate review, and also facilitates electronic data capture. The ARC project team targeted the end of August to finalize the template and begin planning for Phase 2.

Emerging Actuarial Issues Working Group

The working group was formed by the NAIC to address implementation issues resulting from the revisions to AG 38 for universal life products with secondary guarantees. To date the working group has adopted 42 interpretations (INTs) including one during the recent interim period, regarding the basis for determining the pre-funding ratio as defined in Section 8E of AG 38. During this session the working group discussed proposed changes to the previously adopted INT 39, to provide for an adjustment to reflect the exclusion of the IMR from the portfolio in determining portfolio yields. This adjustment is consistent with the VM-20 revision to exclude the IMR in the modelling of the reserves. The proposed VM-20 changes were adopted at the Summer National Meeting, and the proposed INT 39 changes will be considered for adoption on a future conference call.

Submitted questions, exposed responses and adopted interpretations are available on the working group's webpage. Considering the targeted implementation of PBR by January 1, 2017 and the lack of new interpretations being requested, the working group chair suggested that this group may not have any future "live" meetings, but would instead conduct its future business solely through conference calls.

PBR Review Working Group

The working group met in Chicago and received updates from its subgroups.

PBR Blanks Reporting Subgroup
At the 2015 Spring National Meeting, the working group exposed proposed revisions to the Blanks and instructions pertaining to VM-20 (i.e. the VM-20 Supplement) for a second public comment which ended May 29. In Chicago, the PBR Blanks Reporting Subgroup reported that it is considering further edits to the proposed VM-20 Supplement in response to additional comments received from ACLI during the most recent exposure period. The subgroup plans to hold a conference call following the Summer National Meeting to discuss proposed changes.

PBR Review Procedures Subgroup
The subgroup held a conference call on July 28 to discuss draft revisions to the Financial Analysis Handbook to incorporate principle-based valuation guidance developed by NAIC staff. The proposed revisions were exposed for a comment period ending September 11.

Valuation Analysis Working Group
The working group discussed the establishment of a new Valuation Analysis Working Group (VAWG) which will report to the Financial Condition Committee and support member states in their review of PBR. Its goal is to uniformly address questions, issues, interpretation and application of the SVL and VM. The VAWG will be comprised of senior and experienced regulators; membership will be limited to no more than 20 state representatives. VAWG will meet solely in regulator-to-regulator sessions, subject to confidentiality provisions, and may utilize NAIC internal modeling resources and contracted consultants to assess issues and respond to questions. The working group adopted and referred the VAWG Process & Procedures Manual to the Principles-Based Reserving Implementation Task Force, which will consider it on its September 30 conference call.

Health Actuarial Task Force

Long-Term Care
The Society of Actuaries presented the results of its intercompany experience study of LTC claims incidence, termination and benefit utilization rates. The study covers exposures in years 2000-2011 and the resulting experience rate tables reflect a variety of differences in policyholder and benefit characteristics. The research group also developed a database of LTC experience data for use in individual company modeling needs and analysis. Excel-based models were also developed for use with the experience tables. The experience tables, database, Excel models and companion report can all be found on the SOA website.

The results of a joint SOA/LIMRA LTC policy termination experience study were also presented at this session. This study is based on experience during 2000-2011 and includes data from 22 carriers representing 75% of in-force lives. Voluntary lapse rates and mortality rates were reported for a variety of experience categories. The results of this study are also available on the SOA website.

The LTC Actuarial Working Group received a progress report from the Long Term Care Pricing Subgroup on changes to the *NAIC Guidance Manual for Rating Aspects of the Long-Term Care Insurance Model Regulation* (the "Manual") to assist in implementation of changes to the *Long-Term Care Insurance Model Regulation* that were adopted in 2014. Draft changes to the Manual were exposed for comment in February and include a template to facilitate reporting of rating assumptions in rate filings, a checklist of items required in all LTC actuarial memoranda, sample actuarial certifications for rate filings, expanded Question and Answer items, and content related to consumer disclosures. The subgroup held several conference calls during the interim period to discuss comments received and subsequent changes to the Manual, culminating in the adoption of the draft changes by this subgroup and subsequently by the LTC Actuarial Working Group.

Health Reform Solvency Impact Subgroup

The subgroup met three times in April and May to discuss three proposed changes to the Supplemental Health Care Exhibit for 2015 filings. The first proposal (2015-19BWG) would add a "cautionary statement" regarding the SCHE to Blanks Working Group webpage and a reference to the cautionary statement in several places on the exhibit and its instructions. The cautionary statement includes the guidance that the SCHE is meant to report a "preliminary MLR. It is not meant to represent or replicate the MLR calculated by HHS/CMS in its MLR reporting form for actual rebate purposes." The second proposal (2015-20BWG) clarifies the reporting for retrospectively rated contracts including guidance on risk corridor adjustments. The last proposal (2015-21 BWG) would add a new table to Part 1 of the Exhibit to capture receivables and payables related to the 3Rs by state for individual and small group plans. The proposal was adopted over objections from industry, which commented that the disclosures would not provide regulators with useful information. The Blanks Working group adopted all three proposals during its June conference calls.

Contingent Deferred Annuity Working Group

The CDA Working Group continues its consideration of several projects associated with the regulation of contingent deferred annuities. At the Summer National Meeting, the working group discussed proposed revisions to the *Synthetic Guaranteed Investment Contracts Model Regulation* which would exempt CDAs from the scope of the model. The working group agreed to recommend that the Life Insurance and Annuities Committee adopt the proposed revisions.

The working group also discussed proposed cancellation, or nonforfeiture, benefits language which it is considering adding to its draft guidance document, *Guidance for the Financial Solvency and Market Conduct Regulation of Insurers Who Offer Contingent Deferred Annuities*. Industry

representatives continue to encourage the working group to allow flexibility in the market rather than being overly prescriptive to allow for continued product innovation. Consumer protection groups, including the Center for Economic Justice, are advocating for a more prescriptive cash benefit when a CDA is prematurely terminated.

There is general consensus within the working group that some form of cancellation benefit should be required; however further consideration is needed before a final conclusion is reached and specific language is added to the guidance document. In addition to its consideration of the cancellation provisions, the working group is waiting for other NAIC groups to develop a risk management checklist, reserve requirements, and capital requirements for CDAs. Once these items have been completed, the guidance document will be updated further and re-exposed for an additional public comment period. The guidance document is expected to serve as a reference for states interested in modifying their annuity laws to clarify their applicability to CDAs.

Financial Regulation Standards and Accreditation Committee

The committee held a conference call on May 26 and met in Chicago, taking the following actions.

Definition of Multi-State Insurer
During its May 26 conference call, the committee adopted revisions to the Accreditation Preamble which will scope in, for accreditation purposes, "multi-state" captive insurers and special purpose vehicles that assume business written in accordance with 1) Regulation XXX, 2) Regulation AXXX, 3) variable annuities valued under Actuarial Guideline XLIII—CARVM for Variable Annuities (AG 43), or 4) long-term care insurance valued under the *Health Insurance Reserves Model Regulation*. At the Summer National Meeting, the task force voted to implement the changes effective January 1, 2016 for the state regulation of captives that assume XXX and AXXX business. The committee will monitor the ongoing efforts of the VA Issues Working Group as it considers the effective date for captives that assume variable annuities valued under AG 43 and long-term care insurance valued under the *Health Insurance Reserves Model Regulation*. The initial draft proposals were met with strong opposition from both interested parties and certain regulators as the scope of captives to be included for accreditation purposes was viewed as too broad. The final adopted proposal, the scope of which is far more limited, followed a third exposure period and was met with much less opposition since XXX/AXXX captives that are grandfathered under AG 48 will also not be subject to the accreditation standards.

ORSA Model Act
At the Spring National Meeting, the committee received a comment letter from seven major trade associations highlighting an issue related to confidentiality of company information included in the ORSA filings that has arisen as states have begun to adopt the new model act. The committee heard comments that five states have adopted the ORSA model with weakened confidentiality provisions and an additional 5-6 states have introduced similar legislation. The trade associations are requesting that the committee replace the substantially similar confidentiality provisions included in its April, 2013 referral memo with 11 "protections" of company information which should be considered significant elements. The goal of the trade associations' request is to require states to adopt confidentiality language that provides the same level of protection as provided in Section 8 of the *ORSA Model Act*. The committee discussed this issue again at the Summer National Meeting, but did not propose changes to the "substantially similar" criteria. The committee then adopted the Risk Management and *ORSA Model Act* as a new Part A accreditation standard, effective January 1, 2018. The committee may consider the issue further at the Fall National Meeting.

Exposure of Revisions to Accreditation Standards
The committee voted to expose the following new models and model revisions for possible inclusion in the Part A accreditations standards for the requisite one-year seasoning period beginning January 1, 2016.

- The newly adopted *Corporate Governance Annual Disclosure Model Act* and the *Corporate Governance Annual Disclosure Model Regulation*. These model regulations require an insurer (or group of insurers) to provide a confidential filing of its corporate governance practices to the lead state and/or its domestic regulatory annually. (The July 20 SMI Dashboard shows that four states (IN, IA, LA and VT) have already adopted the model and California and Rhode Island are considering adoption.)

- 2014 revisions to the *Annual Financial Reporting Model Regulation* which include an internal audit function requirement for insurers meeting a certain premium threshold.

- 2014 revisions to the *Insurance Holding Company System Regulatory Act* which provide

authority to a designated state to act as a group-wide supervisor of internationally active insurance groups.

2010 Holding Company Model Revisions
The committee heard an update on the adoption of the 2010 revisions to the *Insurance Holding Company System Model Act* and *Regulation*, which are required for accreditation as of January 1, 2016. As of the Summer National Meeting, all jurisdictions except Michigan have adopted the revisions, and Michigan is currently working with its legislature to complete adoption this fall.

Review Team Guideline Revisions
The committee adopted several proposed revisions to the Review Team Guidelines: (1) from the Financial Examiners Handbook Technical Group related to coordinated examination requirements, (2) from the Financial Analysis Working Group related to analysis procedures for domestic insurers which cede to captive insurers or special purpose vehicles business written in accordance with Regulations XXX and AXXX, and (3) the Risk-Focused Surveillance Working Group related to improving communications between financial analysts and examiners. The revisions are effective immediately.

Risk Limiting Contracts Working Group

This newly formed working group held conference calls May 20 and July 30 to discuss its charge of developing "regulatory guidance on how to evaluate risk transfer as it pertains to contracts with risk limiting features and also evaluate how current actuarial/accounting practices used to monitor a company's financial strength need to be enhanced due to distortions from these contracts." During its May 20 call, the working group discussed the types of reinsurance contracts/analysis that some regulators had reviewed which had caused concerns, such as quota share contracts with limits that operate like excess of loss contracts, experience adjustments that are one for one for ceded losses, and risk transfer analyses which uses different assumptions than those used for pricing and reserving. Interested parties asked for examples of contracts with risk-limiting features so that they can respond in more detail to the regulators' concerns.

For the July 30 meeting, the working group provided excerpts from seven types of contracts, including several with sliding scale commissions. Interested parties seems to agree that for these contracts, risk transfer was not "reasonably self-evident" and that further information and analysis would be required.

As the discussion continued, several regulators including the chair expressed the view that perhaps risk transfer is not the primary concern of the working group but instead accounting for the contract and "evaluation of appropriateness of the reinsurance contract for the company." One regulator suggested that the working group develop a checklist that could be used by examiners, accountants and actuaries to determine whether the reinsurance contract is "appropriate and transfers risk." The chair suggested that the working group schedule presentations from interested parties, CPA firms and actuaries to address the accounting for such contracts, and after those discussions consider whether any changes to SSAP 62R or the Financial Condition Examiners Handbook are necessary. (After the July 30 call, the chair left the Illinois Department of Insurance and the NAIC is working to identify a new chair. No future meetings have yet been scheduled.)

Sharing Economy Working Group

Having completed this spring its white paper *Transportation Network Company Insurance Principles for Legislators and Regulators* the working group met by conference call on July 22 and in-person in Chicago to begin its consideration of home-sharing arrangements and issues related to insurance coverage. During the meetings, the working group heard presentations from two home-sharing companies, a service provider to insurers and a trade organization. The presentations focused on the types of protection programs available to the hosts and guests along with details on coverage amounts, history and types of claims.

The trade organization representative observed that insurers have not voiced many concerns regarding home-sharing because of the similar exposures underwritten in a standard homeowners' policy. Additionally, there are no financial responsibility laws with which to comply for homeowners insurance, and legal precedent for liability has not been determined in court cases. To date, only a couple of states have considered legislation regarding home-sharing, and only Florida's proposal contains insurance requirements; the legislation has not yet been adopted.

The chair discussed consumer alerts published by various states and the NAIC and encouraged other states to create their own notices relative to home-sharing. Based on updates from discussions and presentations, the chair noted he believes there are minimal concerns about consumers' risks in this area, and insurers have begun and will continue to

develop products to accommodate home-sharing services. As a result, he recommended that the working group not develop a white paper on home-sharing at this time but continue to study sharing economy issues as they arise.

Casualty Actuarial and Statistical Task Force

Since the Spring National Meeting, the task force met by conference call seven times and in Chicago to discuss the following issues.

Price Optimization
Following the Spring National Meeting, the task force completed drafting its price optimization white paper and recommendations and exposed the document for public comment. The task force received six comment letters, and on July 21, discussed comments requesting clarity and consistency of rules and regulations, the need to factor in real-world applications, broadening the white paper to include practices such as underwriting, tier placement, rating factors and other mechanisms, among other comments. In Chicago, the task force discussed an updated version of the white paper and heard concerns on whether it is the working group's responsibility to define price optimization and whether or not this practice is unfairly discriminatory. The consensus was that price optimization issues should be managed by the states, and the task force will revisit the language to make the white paper more focused on providing guidance as opposed to more definitive language. Following the discussion, the task force exposed the revised white paper for public comment though September 14.

SOA General Insurance Educational Track
Over the spring and summer, the task force continued to work diligently on its charge to evaluate the Society of Actuaries' new general insurance educational track and whether actuaries meeting those requirements should be permitted to sign actuarial opinions for P/C annual statements. After months debating the topic, the task force submitted its response letter to its parent committee on June 30. In its letter, the task force recommended that it needs to evaluate whether the track conforms to the specifications in the U.S. qualification standards and whether the resulting education sufficiently prepares an actuary to sign an actuarial opinion. The task force also raised a concern that while the standards established by the AAA seem sufficient in regard to experience and continuing education requirements, the qualification standards lack detail regarding what a basic education entails. The task force recommended that the issue regarding basic education specificity be addressed later and separately from the above charge. The task force believes it needs to complete an independent study of the examination system before it can determine if individuals completing the SOA general insurance track are qualified to sign P/C Actuarial Opinions.

At the Summer National Meeting, the Executive Committee agreed to conduct and fund an independent review of P/C actuarial credentials and qualifications beginning in late 2015, to be completed in early 2016. The review would be an evaluation of whether U.S. actuarial credentials granted by the CAS and the SOA represent achievement of a high professional standard of actuarial education so that state insurance regulators can rely on the qualification of these credentialed actuaries when signing P/C opinions. This would include hiring a consultant supervised by an ad hoc commissioner group.

Risk-Focused Surveillance Working Group

The working group met by conference call in June and July and met in Chicago to discuss the following topics.

Handbook Redundancy Revisions
The working group discussed and re-exposed another version of revisions to the Financial Condition Examiners Handbook and the Financial Analysis Handbook which aim to reduce potential redundancies in handling of information requests by financial analysis and examination efforts. The additional revisions, which were based on interested party suggestions, focused on the importance of coordination and communication between analysts and examiners as well as the removal of a requirement for the Examination Planning Questionnaire to be customized as a result of an in-person meeting between analysts and examiners prior to distributing the questionnaire to an insurer. The updated guidance still encourages customization but does not require a meeting between functions prior to the distribution of the questionnaire so as not to impact the overall examination timeline.

Following the re-exposure, the working group discussed a joint industry comment letter noting that industry representatives continue to have redundancy concerns that are not being fully addressed by the proposed revisions. Comments were heard and the working group voted to refer the updated revisions to the Financial Analysis Handbook Working Group and the Financial Examiners Handbook Technical Group for consideration of adoption.

Group Profile Summary

The working group discussed a previously exposed proposal and comments received on the Group Profile Summary template which will be incorporated into the Holding Company Analysis Checklist. Following the discussion, NAIC staff worked on drafting revisions which were mainly focused on streamlining the holding company analysis process to flow more seamlessly into the GPS. Revisions include new guidance to allow for flexibility in selecting holding company analysis procedures and determining what information to include in the GPS, and cross-references of holding company analysis procedures to common branded risk classifications to assist analysts in carrying the results of optional procedures forward into the branded risk assessment section of the GPS. The updated guidance also clarifies the role of the Group Profile Summary as the primary deliverable of holding company analysis and the means for sharing the results of the holding company analysis across states and with appropriate federal and international regulators. The working group re-exposed the updated template for comment period until September 18.

Climate Change and Global Warming Working Group

In Chicago, the working group heard a presentation from Mercer on its "Investing in a Time of Climate Change" report. The presentation focused on the report's investment modelling which estimates the potential impact of climate change on returns of portfolios, asset classes and industry sectors between 2015 and 2050 based on four climate change scenarios and four climate risk factors. The four scenarios represent a rise in global temperature of 2°C, 3°C and two 4°C scenarios. The climate risk factors are technological developments, resource availability, impact of climate change and policy decisions. The study was based on Mercer's collaboration with sixteen investment partners collectively responsible for more than US$1.5 trillion.

Results noted the following:

- Climate change will have an impact regardless of scenario; investors will need to take action to understand and mitigate the risks and maximize value at the asset, industry sector and portfolio level.

- Sector impacts are the most meaningful at the industry level, particularly over ten years. Based on climate scenarios, the average returns for the coal industry could decrease by between 18% and 74% over the next 35 years while average returns for the renewables industry could increase by between 6% and 54% over the next 35 years.

- A 2°C scenario does not have negative return implications for long-term diversified investors at a total portfolio level over the next 35 years and is expected to better protect long-term returns beyond this timeframe.

The working group hopes that insights from the report will enable investors to build resilience into their portfolios under an uncertain future.

Mortgage Guaranty Insurance Working Group

The working group met at the Summer National Meeting to discuss its projects.

Model Act and Standards Manual

In Chicago, the working group continued discussing revisions to the fourth version of the previously exposed M*ortgage Guaranty Insurance Model Act* issued earlier in February. The working group heard concerns pertaining to Section 10 on reinsurance purchased from non-U.S. reinsurers. As is currently drafted, the model act would require that 100% collateral be posted for such reinsurance agreements in order for the ceding insurer to meet its modified RBC standards and industry loan level capital standards. This is inconsistent with the *Credit for Reinsurance Model Law* and *Regulation* which provides a framework for reduced collateral requirements for financially strong non-U.S. reinsurers domiciled in approved jurisdictions. Following the discussion, the working group directed the chair to develop a revised draft to address comments received. With respect to timeline, work is progressing with completion expected by spring 2016.

The working group heard an update on the progress of the second version of the previously exposed Mortgage Guaranty Insurance Standards Manual, which will be referenced in the model act. Comments received from a trade organization have been addressed and revisions to the draft have been made. Shortly after the Summer National Meeting, the working group distributed a clean draft of the model law and the standards manual with a comment deadline of November 20.

Capital Model

The chair informed that mortgage insurer data has been received and work is being completed with the

help of NAIC IT staff. Additionally, work is progressing with state actuaries participating in testing the capital model.

Terrorism Insurance Implementation Working Group

The working group met via conference call on April 21 and July 9 to discuss the data collection requirements contained within the updated Terrorism Risk Insurance Act which was adopted by Congress and signed into law by President Obama in January 2015 (TRIA2015). Section 104(h), Reporting of Terrorism Insurance Data, requires the U.S. Department of Treasury, presumably under the auspices of the Federal Insurance Office, to collect certain types of information from insurers. The section also indicates that the effort should be coordinated with the appropriate state regulators to determine if information to be collected is available. Giving consideration to this provision, the working group concluded it should initiate an effort to collect certain terrorism insurance data within the annual statement filings.

With the intent of collecting 2015 premium volume and policy count data associated with terrorism risk within the 2015 year-end annual statement filings, the working group developed a proposed Terrorism Risk Insurance Supplement (2015-24BWG) on an aggressive timeline. The proposal was exposed for public comment by the Blanks Working Group through an e-vote on July 15 and comments received from interested parties on the proposed supplement were discussed August 5. Industry trade associations expressed strong opposition to the supplement citing the lack of available information, the lack of due process, and the unknown with respect to the information that FIO will ultimately seek from the industry. While the Blanks Working Group approved certain modifications to the proposed supplement on the August 5 call, it deferred adoption of the supplement, requesting the working group and industry representatives try to reach consensus prior to the Summer National Meeting.

At the Terrorism Insurance Implementation Working Group's meeting in Chicago, NAIC staff reported on the August 12 FIO stakeholder meeting related to terrorism insurance data where interested parties shared similar concerns to those expressed regarding the proposed supplement. The FIO has acknowledged that it is plans to begin collecting data referenced in TRIA2015 during 2016. FIO Director Michael McRaith, who attended the working group's meeting in Chicago, stated that he welcomes input from state insurance regulators, with a goal of avoiding a duplication of data-collection efforts; however, he did not give any indication that FIO would leverage the proposed supplement being considered by the NAIC.

During the Blanks Working Group meeting in Chicago, industry representatives reiterated their opposition to the proposed supplement. Following extensive discussion, the working group voted to adopt the supplement with two working group members voting against the proposal. The debate then shifted to the APP Task Force, which subsequently rejected the supplement. During the following day's meeting of the Financial Condition Committee, the chair announced that a data call of companies will be organized to obtain the data needed to comply with the TRIA2015.

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The next National Meeting of the NAIC will be held in Washington DC November 19-22. We welcome your comments regarding issues raised in this newsletter. Please provide your comments or email address changes to your PricewaterhouseCoopers LLP engagement team, or directly to the NAIC Meeting Notes editor at jean.connolly@us.pwc.com.

Disclaimer

Since a variety of viewpoints and issues are discussed at task force and committee meetings taking place at the NAIC meetings, and because not all task forces and committees provide copies of agenda material to industry observers at the meetings, it is often difficult to characterize all of the conclusions reached. The items included in this Newsletter may differ from the formal task force or committee meeting minutes.

In addition, the NAIC operates through a hierarchy of subcommittees, task forces and committees. Decisions of a task force may be modified or overturned at a later meeting of the appropriate higher-level committee. Although we make every effort to accurately report the results of meetings we observe and to follow issues through to their conclusion at senior committee level, no assurance can be given that the items reported on in this Newsletter represent the ultimate decisions of the NAIC. Final actions of the NAIC are taken only by the entire membership of the NAIC meeting in Plenary session.

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AUTHORS WANTED

The Publications Committee is looking for members to write articles for the quarterly Examiner magazine. Authors will receive six Continuing Regulatory Credits (CRE) for each technical article selected for publication.

Interested authors should contact the Publications Committee Chair, **Tian Xiao**, via **sofe@sofe.org**.

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