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Managing the Unmanageable: The Future of the NFIP and the Private Flood Insurance Market

Multiple Choice/True or False Questions — Submit Answers Online

1. The Homeowners Flood Insurance Affordability Act of 2014 improved the financial stability of the NFIP through significant rate increases and the removal of subsidies to homeowners in flood-prone areas.

   a. True
   b. False

2. The National Flood Insurance Program is administered by which U.S. Government agency?

   a. Office of Emergency Management
   b. Federal Emergency Management Agency
   c. Risk Management Agency
   d. National Weather Service

3. State guarantee funds are not utilized to pay NFIP flood-related claims as the NFIP is a federal program.

   a. True
   b. False

4. The NFIP has suffered significant losses over the past decade due to major storms that include all of the following except:

   a. Hurricane Andrew
   b. Hurricane Katrina
   c. Superstorm Sandy
   d. Hurricane Harvey

5. Higher commissions on standard property coverage in the private market than on NFIP policies has incentivized growth of the private market flood insurance.

   a. True
   b. False

Financial Instruments Enhanced Reporting Model: White Paper November 2018

True or False Questions — Submit Answers Online

6. The subject matter for Accounting Standards Update (ASU) 2016-01 includes all types of equity based securities with no exclusions.

   a. True
   b. False

7. The new ASU 2016-01 reporting model for equity securities requires that any changes in the fair value of the securities are recognized in net income or other comprehensive income.

   a. True
   b. False

8. Under ASU 2016-01, equity securities that do not have readily determinable values, and cannot be readily valued using the Net Asset Value per share method, can be elected to be measured at cost, less any impairment, plus or minus changes in value from orderly transactions for identical or similar securities.

   a. True
   b. False

9. Under ASU 2018-13, for Debt securities, FASB continues to require disclosure of debt securities held at amortized cost.

   a. True
   b. False

10. The Under ASU 2018-13, Financial disclosure of financial assets and liabilities require a distinct and separate category for both Debt and Equity securities according to their respective measurement category.

    a. True
    b. False

Cannabis: From Criminality to Commercial Enterprise

True or False Questions — Submit Answers Online

11. You violate the Control Substance Act of 1970 if you sell Marijuana in a state that legalized the sale and distribution of the product.

    a. True
    b. False

12. Worker's Compensation carriers can cite the Control Substance Act of 1970 as a valid defense to not pay a marijuana-related medical claim in states that legalized marijuana use.

    a. True
    b. False

13. Marijuana growers have a heightened-risk profile for insurance companies due to the equipment used in the growing of the plants.

    a. True
    b. False

14. There are very few admitted property/casualty insurers for the Cannabis Industry which has them looking at surplus line carriers or creating captive insurers.

    a. True
    b. False

15. From 1969 to current, the U.S. population's view on legalized marijuana has grown more negative.

    a. True
    b. False

PwC NAIC Newsletter - NAIC Fall 2018 National Meeting

True or False Questions — Submit Answers Online

16. The Statutory Accounting Principles Working Group passed revisions to SSAP 41R (Surplus Notes) to disallow capital treatment for surplus notes which are linked to other securities/structures that are not subordinate.

    a. True
    b. False

17. The Valuation of Securities Task Force adopted an amendment to change the Not Rated ("NR") symbol to Not Designated ("ND"). This change will be effective December 31, 2019.

    a. True
    b. False

18. The Risk-focused Surveillance Working Group adopted guidance for the Financial Condition Examiners Handbook to include a new Exhibit D, "Planning Meeting with Financial Analyst".

    a. True
    b. False

19. The Casualty Actuarial and Statistical Task Force adopted an actuarial attestation form that will be completed and signed annually to verify that the actuary is qualified to sign a statutory P&C Statement of Actuarial Opinion.

    a. True
    b. False

20. The Reinsurance Task Force adopted its proposed revisions to the credit for reinsurance models, including a provision to eliminate reinsurance collateral provisions on new reinsurance contracts for EU- based reinsurers meeting the conditions of the U.S./EU Bilateral Agreement. The final revisions were sent to the Executive Committee and Plenary but have not yet been adopted by the Executive Committee and Plenary.

    a. True
    b. False

Managing the Unmanageable: The Future of the NFIP and the Private Flood Insurance Market

By Fred E. Karlinsky, Richard J. Fidei, Benjamin J. Zellner and Christian Brito, Greenberg Traurig LLP

Floods are the most common natural disaster in the United States. Flood risk affects all 50 states; 4.2 million homes representing $1.1 trillion in property exposure are at risk of flooding from hurricane storm surge, including $793 billion in Atlantic coast exposure and $354 billion in Gulf coast exposure. Further, the risk expected to grow due to climate change and more people living near the coast.

The insurance industry has historically struggled to cover flood risk. Private industry largely withdrew from the flood insurance market in the aftermath of several severe flood events along the Mississippi River in the 1920's, and massive uninsured losses resulting from major floods in the 1960's highlighted the magnitude of the problem.

In response, Congress created the National Flood Insurance Program ("NFIP") in 1968. The program, which is administered by the Federal Emergency Management Agency, provides federally subsidized flood insurance to homeowners and businesses in flood zones. All properties located in 100-year flood plains, known as Special Flood Hazard Areas (SFHAs), must have flood insurance if there is a mortgage or loan from a federally backed lender. Communities in SFHAs must participate in the NFIP and implement certain measures to mitigate flood damage. While the insurance is purchased through private insurers, the federal government backs the policies and is ultimately financially responsible for covered losses.

The NFIP was expected to largely pay for itself through premiums collected, and it was anticipated that mitigation measures would allow private insurers to re-enter the market. Unfortunately, that vision failed to materialize. Over time the NFIP suffered significant losses, which spiked over the past decade due to Hurricane Katrina, Superstorm Sandy and other major storms. Indeed, nine out of the ten costliest events for the NFIP occurred since 2000. The 2017 hurricane season has proven to be one of the most damaging on record. Three major storms struck the U.S., causing an estimated $200 billion in damage.[1] Much of the damage was caused by floods, particularly in and around Houston, where Hurricane Harvey slowly moved over the area.

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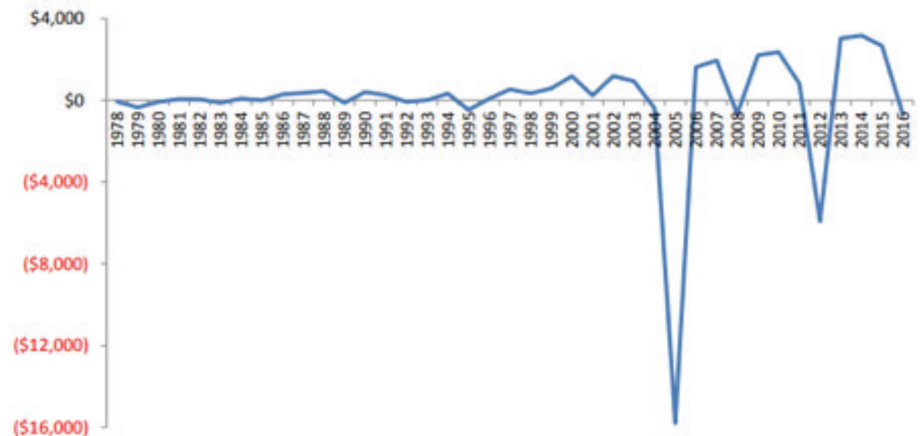
[1] *Karma Allen & Maia Davis, Hurricanes Harvey and Irma May Have Caused up to $200 Billion in Damage, Comparable to Katrina, ABC NEWS (Sept. 11, 2017, 8:09 PM), http://abcn.ws/2jihHxB.*



These losses caused the NFIP to borrow more and more money from the U.S. Treasury. Prior to the 2017 hurricane season, the NFIP's debt to the Treasury Department was around $25 billion. The 2017 hurricane season led to over $8 billion in losses incurred by the NFIP, and it became clear that the program would be unable to pay all claims, as its cash on hand, reinsurance and remaining borrowing authority were well below the estimated losses.

The problem was partially addressed by enactment of a disaster relief bill that, among other things, forgave $16 billion of the NFIP's debt, thus permitting it to borrow additional amounts to pay claims. However, the long-term problem of the NFIP's financial position remains unresolved.

The growing financial strain on the program has spurred efforts to make it more financially sound. The last major enacted reform was the Biggert-Waters Flood Insurance Reform Act of 2012, sometimes called BW-12. That law made various reforms to improve the program's financial position, the most notable of which were significant rate increases and the removal of various subsidies to homeowners in flood-prone areas. These reforms proved politically unpopular due to the extremely large rate increases homeowners experienced, and the loss of subsidies made it difficult, if not impossible, for some people to insure their home or business.

Higher flood insurance rates also affected local housing markets, as some prospective buyers realized they would be unable to afford the flood insurance premiums on a property. The backlash led Congress to repeal many of the provisions of BW-12 in 2014 by passage of the Homeowners Flood Insurance Affordability Act, which reinstated some of the subsidies and capped rate increases. Some insureds also received refunds for higher rates that they had paid under BW-12. The partial repeal of BW-12 may have satisfied some homeowners, but the financial viability of the program remained an open issue.

Although Congress unwound many of the reforms implemented by BW-12, significant provisions of the law remain in effect. BW-12 contains provisions that opened up the residential flood insurance market to private homeowners insurers by directing federal mortgage lenders to accept loans secured by mortgages on properties in flood zones if the property is covered by an NFIP-compliant policy issued by a private insurer.

Such private policies must be at least as broad as the coverage in the standard NFIP policy form, and must offer limits of $250,000 or the balance of the loan, whichever is less. The private policy must also have comparable deductibles, exclusions and conditions. Some ambiguities remain in the law, but BW-12 nevertheless remains a significant step toward increased participation by private insurance companies in the flood insurance market.

The size of the flood insurance market in the U.S. has further helped spur interest in expanding the private flood insurance market. Roughly $4.3 billion in total premiums was generated in 2016 from more than 5 million policies issued by the NFIP. Even at this volume, only about 20 to 30 percent of homeowners who should purchase flood insurance do so. Hurricane Harvey demonstrated the magnitude of this issue, as an estimated 70 percent of flood damage caused by that storm is not covered by insurance[2].

A piece of these losses will ultimately be borne by the property owners themselves or various governmental disaster relief programs. In 2017, President Trump signed a $36.5 billion disaster relief package designed to aid victims of the 2017 hurricanes (although some of this amount will also go to victims of the 2017 California wildfires).[3] That amount was in addition to tens of billions in funds previously appropriated for disaster relief and included $16 billion to address the financially strapped NFIP.

This is a potentially very large market available for private companies to enter, as well as an incentive for the federal government to encourage development of a private market. Private insurers' interest in the flood market has also been spurred on by advances in catastrophe modeling, which have allowed insurers to better underwrite and price flood risks. More sophisticated catastrophe models, as well as access to more historical loss data, more accurate measurements of property elevations and other underwriting information, have increased the private market's confidence in its ability to cover flood risk and, consequently, calls for changes in the law to make the private market more viable.

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[2] *Harvey Residential Insured and Uninsured Flood Loss $25-$37 Billion: Corelogic, REUTERS, Sept. 1, 2017, http://reut.rs/2ySfBai.*

[3] *https://www.nbcsandiego.com/news/politics/House-GOP-Pushing-Disaster-Relief-for-Hurricanes-Fires-465066293.html.*

While the private flood insurance market has grown in recent years, it remains a small player in covering flood risk in the U.S. Detailed statistics on the existing private market are not available, but it is estimated to be only a fraction of the size of the NFIP. Most private flood policies are issued by surplus lines carriers, not admitted carriers, although there is significant interest from admitted insurers looking to take advantage of this market. There are, of course, many significant issues that need to be addressed for growth in the private market to accelerate, including legislative obstacles. While BW-12 instructs federal mortgage lenders to accept mortgages on properties with private flood policies, federal banking and housing agencies may still impose their own solvency requirements on the insurance companies issuing the policies.

State insurance regulators and the industry oppose the imposition of federal requirements on carriers. The industry does not want to have to comply with two sets of standards. Another fundamental issue is that the subsidized rates offered by the NFIP make it difficult for private insurers to compete. The BW-12 reforms would have made private insurance more competitive by making NFIP rates more reflective of the risk covered (actuarially sound rates). However, the repeal of most rate increases and reinstatement of subsidies has left this problem unsolved. Rate increases have proved politically unpopular in the past, and they may continue to be in the wake of the 2017 hurricane season.

Despite difficulties, several proposals were advanced in Congress in 2017. The most consequential is likely the Private Flood Insurance Market Development Act of 2017, H.R. 1422, sponsored by Republican U.S. Rep. Dennis Ross of Florida. The bill clarifies that policies issued by insurance companies, including both admitted and surplus lines carriers, that are licensed or otherwise approved to engage in insurance in the state where the property is located are acceptable for federal mortgage lenders. The National Association of Insurance Commissioners has voiced support for similar bills in the past, and for federal legislative confirmation that state insurance regulators will have the same authority to regulate private flood insurance products as they do to regulate other insurance products — an issue that BW-12 does not clarify. The bill enjoys bipartisan support in the House of Representatives and was unanimously passed out of the Committee on Financial Services in July. An identical bill was introduced in the Senate and referred to the Committee on Banking Housing, and Urban Affairs, but to date has not moved.

The momentum toward adoption of pro-private market reforms to the NFIP seems to have been slowed by the impact of Hurricanes Harvey, Irma and Maria in 2017, which may have reduced the publics' and legislators' appetites for a reduction in the federal government's subsidization of flood insurance. In July 2017, 26 Republican representatives from districts with significant flood risks sent a letter to Republican House leadership indicating that they could not support the reform bills that had been passed out of the Financial Services Committee. Some Democrats have also voiced skepticism at attempts to reduce the NFIP's subsidies.

An opportunity for reform remains, however, as the NFIP is currently set to expire on Nov. 30, 2018, meaning that Congress must take some action with regard to the program. The original expiration date, which was Sept. 30, 2017, has already been extended several times due to the turmoil created by the 2017 storms and focus on tax reform, but reauthorization remains on Congress's immediate agenda. Opposition to efforts to encourage a private market often revolves around the potential effect on the NFIP. Opponents of privatization efforts voice concerns that the private market will cherry-pick the best risks and leave policies in the NFIP that will not be affordable without large subsidies. This would create a sort of death spiral for the NFIP, which would basically become a flood insurance subsidization program and likely create new political problems concerning the fairness of such a program.

Some have expressed support for such a development and say it would permit Congress to better address the long-term problem of people building in areas that are highly prone to flooding. Another obstacle to increased private sector involvement is that agents currently receive a higher commission for policies placed with the NFIP than they do for more standard property coverage in the private market. This creates a significant incentive for agents to place policies with the NFIP. It is an issue that will need to be addressed for the private market to become more viable.

How private flood insurance will be handled with regard to state guarantee funds is another unresolved issue. As a federal program, the federal government ultimately pays for claims on NFIP policies, so state guarantee funds are currently not tapped to pay flood-related claims. As the private flood market grows, the question of whether the states' guarantee funds will protect policyholders whose flood insurer has become insolvent will become more pressing. There is currently a debate over whether states should start imposing guarantee fund assessments to private flood policies or if they should simply declare that their guarantee funds will not cover flood insurance policies. This is an issue for each individual state to decide. But if the private market grows significantly, the pressure will build for a state backstop for insolvencies.

The fate of the NFIP and the potential for growth of the private flood insurance market remain murky. What is clear, however, is that the private market will not expand significantly without major reforms to the NFIP. There seems to be a consensus that some reforms are necessary, but whether changes will promote the private sector or only solidify the NFIP's role as the nation's flood insurance provider is unclear. The only certainty is that more storms will come, and the cost of the damage must be paid.

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Financial Instruments Enhanced Reporting Model: White Paper November 2018

By Josh Keene, Magali Welch, and Lauren Williams of Johnson Lambert LLP

Johnson Lambert LLP is dedicated to keeping you current on the impact the Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 2016-01, Financial Instruments Recognition and Measurement, ASU 2018-03, Improvements to Financial Instruments, and ASU 2018-13, Changes to the Disclosure Requirements for Fair Value Measurement will have on financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). This white paper presents the most impactful changes to the reporting model for equity securities and certain modifications to disclosures for financial instruments

Background

In 2008, the FASB and International Accounting Standards Board (IASB) embarked on a joint project to explore improvements to financial instruments accounting standards. Although the FASB and the IASB worked together for several years, the FASB ultimately elected to only make targeted improvements to existing GAAP.

Overview and Effective Dates

The guidance introduces a new reporting model for equity securities whereby changes in fair value are recognized in net income and an alternative measurement model for equity securities without readily determinable fair values. The FASB also made several amendments to improve the effectiveness of certain disclosures.

The FASB issued ASU 2016-01 in January 2016 and ASU 2018-03 in February 2018, which are effective for non- public, calendar year-end filers December 31, 2019, with early adoption permitted no sooner than first quarter2018. The FASB issued ASU 2018-13 in August 2018, which is effective for non-public, calendar year-end filers December 31, 2020, with early adoption permitted.

Equity Securities

Impacted Equity Securities
The term equity securities encompass a variety of financial instruments, ranging from common stocks, preferred stocks and mutual funds to ownership interests in partnerships, unincorporated joint ventures and limited liability companies. ASU 2016-01 specifically excludes those securities accounted for under the equity method and consolidated subsidiaries.

New Reporting Model
The new reporting model requires entities to measure most equity securities at fair value and recognize changes in fair value in net income. This change should be applied prospectively via a cumulative-effect adjustment on the first day of the fiscal year of adoption. (see illustration in Appendix A).

As the change in the fair value of equity securities now flows through the income statement, an entity with a substantial equity security portfolio may experience significant volatility in earnings.

Alternative Model

Historically, insurance companies were required to report all equity securities at fair value, even those where fair value was not readily determinable. Now an entity may elect a measurement alternative for equity securities that do not have readily determinable fair values and do not qualify for the practical expedient to estimate fair value using the net asset value (NAV) per share (or its equivalent). This alternative may be advantageous for some entities, as it allows entities to measure securities at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of the same issuer. A separate election to use the alternative model is required for each eligible security and must be applied consistently until the security's fair value is readily determinable. An assessment of whether the security is eligible to use the measurement alternative must be performed at each reporting period. Adjustments made resulting from observable price changes should reflect the fair value of the security as of the date the observable transaction occurred, not the current reporting date.

The guidance also allows securities that do not have readily determinable fair values to be remeasured at fair value either upon (1) the occurrence of an observable price change or (2) identification of an impairment.

Upon concluding an impairment exists, the difference between the carrying value and fair value is recognized as an impairment in net income. Impairment indicators may include significant deterioration or adverse changes in the credit rating, earnings performance, economic, regulatory or technological environment of the investee, or in the general market in which the investee operates.

At adoption, insurance companies should apply a prospective method consistently to the entire population of securities for which the measurement alternative is elected. An entity may subsequently elect to measure the securities at fair value. This election is irrevocable and should be applied to all identical or similar securities. Any resulting gains or losses are recorded in net income at the time of the election.

An entity electing the alternative model must disclose:

- The carrying amount of securities without readily determinable fair values.
- The amount of annual and cumulative impairments and downward adjustments, if any.
- The amount of annual and cumulative upward adjustments, if any.

- Narrative information to help financial statement readers understand the quantitative disclosures, including the information considered in determining the carrying amounts and adjustments resulting from observable price changes (as of the current reporting date).

At adoption, an entity is required to disclose the following:

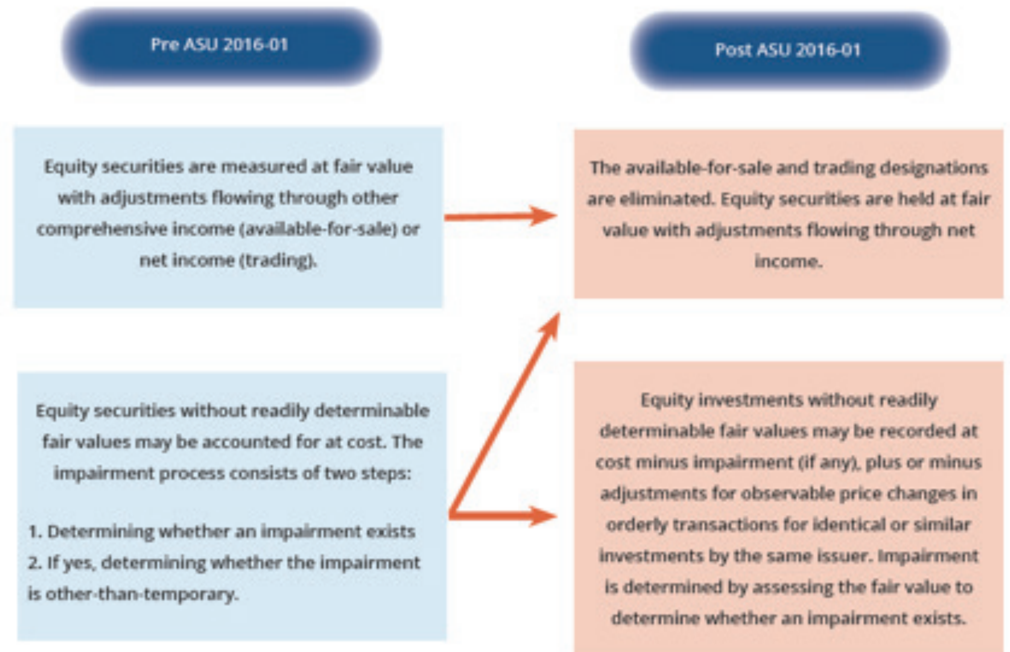
- The nature of and reason for the change in accounting principle, with an explanation of the newly adopted principle.
- The method of applying the change.
- The effect of the adoption on any line in the statement of financial position, if material, as of the beginning of the fiscal year of adoption.
- The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the fiscal year of adoption.

Debt Securities

The FASB also made the following amendments related to debt securities:

- Eliminated the requirement to disclose the fair value of debt securities held at amortized cost.
- Requires an entity to evaluate the need for a valuation allowance on deferred tax assets (DTAs) related to available-for-sale debt securities in conjunction with the entity's other DTAs, rather than separately evaluating its ability to realize such DTAs by considering its intent and ability to hold the debt securities until recovery or maturity.

Summary of Key Revisions



Improved Disclosures

New Disclosures

Financial assets and financial liabilities must be presented separately by measurement category and form on the balance sheet or in the notes to the financial statements, as illustrated below.

	As of 12.31.18
Debt Securities – Available-for-Sale	$1,200,000
Debt Securities – Held to Maturity	100,000
Debt Securities – Trading	500,000
Debt Securities – Fair Value Option	250,000
Equity Securities	200,000
Premium Receivables	350,000
Loan Receivables	10,000

Eliminated Disclosures

The following disclosures are no longer required:

- The amount and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy.
- The policy for timing of transfers between levels.
- The valuation processes for Level 3 fair value measurements.
- The changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the reporting period.

Modified Disclosures

Rather than provide a roll forward for Level 3 securities, entities will disclose transfers into and out of Level 3 and purchases and issues of Level 3 assets and liabilities. An entity that invests in certain entities that calculate NAV, is required to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse only if the investee has communicated the timing to the entity or announced the timing publicly.

Appendix A
Illustrations

The following illustrations show the impact of ASU 2016-01 on the statement of income and statement of shareholders' equity. For illustrative purposes, the entity early adopted the ASU in 2018 and the investment portfolio consists solely of equity securities.

Statement of Income

Year Ended December 31, 2018

	Pre ASU 2016-01	Impact of ASU 2016-01	Post ASU 2016-01
Revenues			
Premiums earned	$400,000		$400,000
Other income	10,000		10,000
Net investment income earned	30,000		30,000
Unrealized gains on equity securities[1]		44,430	44,430
Net realized capital gains	40,000		40,000
Total revenues	480,000		524,430
Loss and expenses			
Losses and loss adjustment expenses incurred, net	300,000		300,000
Commissions expense	50,000		50,000
Selling, general and administrative expenses	50,000		50,000
Depreciation expense	20,000		20,000
Total expenses	420,000		420,000
Income before tax expense	60,000		104,430
Income taxes			
Current expense	14,000		14,000
Deferred expense[2]	5,000	9,330	14,330
Total income tax expense	19,000		28,330
Net income	41,000		$76,100
Other comprehensive income:			
Unrealized holding gain, net of deferred income tax expense of $17,330	66,700		
Reclassification adjustment, net of income tax expense of $8,400	(31,600)		
Other comprehensive Income	35,100		
Total comprehensive income	$76,100		

[1]Unrealized gains and losses are reported gross of tax.
[2]The tax effect of unrealized gains and losses are reported as a deferred expense.

Statement of Shareholders' Equity

Pre ASU 2016-01

	Common Stock	Accumulated Other Comprehensive Income, Net of Tax	Retained Earnings	Total
January 1, 2018	$10,000	$100,000	$2,000,000	$2,110,000
Other Comprehensive Income		35,100		35,100
Net income			41,000	41,000
December 31, 2018	$10,000	$135,100	$2,041,000	$2,186,100

Post ASU 2016-01

	Common Stock	Accumulated Other Comprehensive Income, Net of Tax	Retained Earnings	Total
January 1, 2018	$10,000	$100,000	$2,000,000	$2,110,000
Impact of adoption of ASU 2016-01		(100,000)	100,000	-
Net income			76,100	76,100
December 31, 2018	$10,000	$ -	$2,176,100	$2,186,100

References:

ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, January 2016

ASU 2018-03, Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, February 2018

ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement, August 2018

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Cannabis: From Criminality to Commercial Enterprise

Understanding the Intersection With Property/Casualty Insurance

By Jon Bergner, Andrew Pauley, Paul Tetrault, and Andrew Malin of National Association of Mutual Insurance Companies (NAMIC)

INTRODUCTION

Marijuana, a product of the cannabis plant, has long been recognized for its medicinal uses and psychoactive effects produced by its chemical compounds cannabidiols (CBD) and tetrahydrocannabinol (THC). It is a Schedule I drug under the Controlled Substance Act of 1970. Despite its tangled legal status, it is also a product at the heart of a growing and increasingly legitimized industry and a topic on which property/casualty insurers increasingly need to be informed. In 2017 alone, the legal cannabis industry generated $9 billion in sales in the U.S. and is expected to grow to $21 billion by 2021. [(1)] Cannabis may serve as an alternative to highly addictive opioids and is also used by some doctors to treat symptoms of anxiety, depression, Parkinson's disease, post-traumatic stress disorders, AIDS, cancer, and a host of other medical conditions.

As of October 2018 marijuana is legal for medical use in 30 states and the District of Columbia, decriminalized in 22 states and the D.C., and available for recreational use in nine states and D.C. [(2)] The legal landscape shifted dramatically in recent years, and public opinion on the legalization of marijuana has transformed significantly with no sign of relenting anytime soon. If current trends continue, it will be critical for property/casualty insurance companies to have at least a basic understanding of cannabis and the cannabis industry and how they both intersect with insurance industry products and services.

This paper explores the issues and complexities at the intersection of the insurance industry and the burgeoning cannabis industry, including a review of the legal landscape surrounding it. While the legalization of marijuana can be a politically divisive subject, there is value in insurers developing an understanding of how the issues at play will affect their companies. Given recent trends, it is increasingly impractical for insurers to ignore the rapidly transforming cannabis landscape.

SURVEYING THE CANNABIS LEGAL LANDSCAPE

The modern story of cannabis begins in the 1830s with an Irish physician by the name of William O'Shaughnessy. O'Shaughnessy was working in India when he discovered that extracts from the cannabis plant could reduce vomiting and stomach pain in cholera patients. [(3)] From this limited medicinal use, it did not take long before the psychoactive effects produced by the THC in cannabis were discovered and the plant's cultivation and distribution began to spread across the globe. Recreational use of cannabis emerged in the U.S. in the early 20th century.

Cannabis's place in society – and the question of its legality – was debated during the Prohibition era and throughout the ensuing decades, culminating in 1970 when President Richard Nixon signed into law the Controlled Substances Act designating cannabis as a Schedule I drug and making its possession, distribution, and sale a punishable offense under federal law. [(4)]

A drug's federal scheduling is based on a consideration of three criteria:

1) Medical use

2) Potential for abuse

3) Safety or dependence liability [5]

Schedule I drugs are those with "no currently accepted medical use and a high potential for abuse" compared to Schedule V drugs that are "drugs with lower potential for abuse than Schedule IV and consist of preparations containing limited quantities of certain narcotics." [7] Examples of other Schedule I drugs include heroin, lysergic acid diethylamide (LSD), and methylenedioxymethamphetamine (ecstasy). Examples of Schedule V drugs (the most innocuous classification) include Robitussin, Lyrica, and Lomotil.

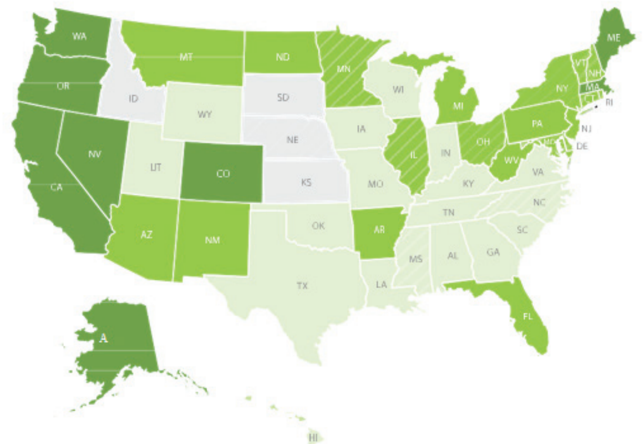
	Schedule I	Sched- ule II	Schedule III	Sched- ule IV	Schedule V
Potential for abuse	The drug or other substance has a high potential for abuse	The drug or other substance has a high potential for abuse	The drug or other substance has a potential for abuse less than the drugs or other substances in schedules I and II	The drug or other substance has a low potential for abuse relative to the drugs or other substances in schedulesIII	The drug or other substance has a low potential for abuse relative to the drugs or other substances in schedulesIV
Medical use	The drug or other substance has no currently accepted medical use in treatment in the United States	The drug or other substance has no currently accepted medical use in treatment in the United States or a currently accepted medical use with severe restrictions	The drug or other substance has a currently accepted medical use in treatment in the United States	The drug or other substance has a currently accepted medical use in treatment in the United States	The drug or other substance has a currently accepted medical use in treatment in the United States
Consequences of abuse	There is a lack of accepted safety for use of the drug or other substance under medical supervision	Abuse of the drug or other substance may lead to severe psychological of physical de- pendence	Abuse of the drug or other sub- stance may lead to moderate or low physical dependence or high psychological dependence	Abuse of the drug or other substance may lead to limited physical depen- dence or psychological dependence rel- ative to the drugs or other substances in schedule III	Abuse of the drug or other substance may lead to limited physical depen- dence or psychological dependence rel- ative to the drugs or other substances in schedule IV
	Marijuana, Heroin, LSD, Ecstasy, Peyote	Cocaine, Vicodin, Fentanyl, Adderall, Ritalin	Codeine, Ketamine, Steroids	Xanax, Soma, Tramadol	Robitussin, Lyrica, Lomotil

Neither state prohibitions nor the federal prohibition stopped cannabis from being a popular recreational drug over the subsequent decades, [8] likewise for the "Just Say No" campaign and the so-called "War on Drugs" championed to various degrees by governments at the federal, state, and local levels. To the contrary, marijuana use persisted and held a place in popular culture. At the same time, there was growing belief regarding its efficacy as a remedy for the side effects of chemotherapy treatments.

California became the first state to take action in what would become a significant trend to legalize the use of marijuana when it passed the Compassionate Use Act of 1996. This law permitted the treatment of severe and chronically ill patients with marijuana and set in motion a wave of initiatives across the country to introduce legislation legalizing first the medical, and later the recreational use, possession, distribution, and sale of marijuana under state law. [9]

U.S. MARIJUANA LAWS, CURRENT STATUS [10]

- ILLEGAL
- CBD & LOW-THC USE
- ALLOWED MEDICINAL USE
- ALLOWED RECREATIONAL
- USE ALLOWED
- DECRIMINALIZED



As of October 2018, 30 states and the District of Columbia have legalized marijuana for medical use, nine states and the D.C. have legalized it for recreational use, and 22 states and the District of Columbia have decriminalized it.

Typically, legalization of marijuana means individuals cannot be arrested, ticketed, or convicted for using marijuana if they follow the state laws as to age, place, reason, and amount for consumption. [11] In addition, legalization is accompanied by state and local governments involvement in regulating and taxing the production, distribution, and sale of cannabis products.[12] In states that have legalized the recreational or medical use of marijuana, all individuals and businesses following the state or locality-specified marijuana requirements will not have criminal liability under state or local law.

Legalization is different from a state decriminalizing marijuana possession, which typically means "certain small, personal- consumption amounts are a civil or local infraction, not a state crime (or are a lowest misdemeanor with no possibility of jail time)," according to the National Conference of State Legislatures. [13] It is important to note that the definition of "small amounts" of marijuana possession varies from state to state. For example, in New Hampshire, possession of three-quarters of an ounce or about 21 grams or less of marijuana is classified as a civil violation and results in a $100 fine for the first offense. [14] In Illinois, possession of 10 grams or about a third of an ounce or less constitutes a civil offense and $200 maximum fine. [15] Further, decriminalization usually refers only to possession and does not typically mitigate the legal penalties associated with the distribution and sale of marijuana.

Just as with decriminalization, the specifics of the legal use of marijuana vary greatly from state to state. The legal specifications are typically broken down into the following categories:

- Possession limit
- Form of consumption (smoked, edible, or liquid forms)
- Whether it can be purchased at a dispensary and whether those dispensaries can operate as for-profits or non-profits
- Whether it can be cultivated at home
- Purchasing reciprocity with other legal-status states [16]

A comparison of medical marijuana laws in New York and Nevada helps to highlight the complexity of the patchwork of state laws. In New York, patients must have one of several specified debilitating or life-threatening conditions such as cancer, HIV, or multiple sclerosis; be at least 21 years old; and may only possess a 30-day supply with the actual quantity to be determined by a physician and "no individual dose may contain more than 10 milligrams of THC." [17] Additionally, medical marijuana may only be administered as a liquid, oil, or capsule, rather than smoking or as an edible (infused in food). Additionally, New York does not permit home cultivation. [18]

Across the country in Nevada, marijuana may be used to treat "chronic or debilitating medical conditions," such as AIDS, cancer, or glaucoma for those 18 years and older. [19] In addition, home cultivation is allowed but only if the patient lives more than 25 miles from a dispensary or cannot find a dispensary with the needed strain. [20] The possession limit for medical use is "two and one-half ounces of usable marijuana in any 14-day period and up to 12 plants, irrespective of whether they are mature or immature" or "for purposes of edible and marijuana-infused products, the total amount of THC in any one 14-day period cannot exceed 10,000 milligrams." [21]

A CANNABIS PATCHWORK

The significant variations in marijuana laws extend into the realm of taxation, state and local application processes and fees, capital requirements for dispensaries, and cost of licenses for businesses for cultivation, dispensaries, manufacturing, testing, and more. These differing specifications among states create a patchwork that can be confusing for anyone attempting to understand marijuana laws across the country.

WOULD RESCHEDULING CANNABIS MAKE IT LEGAL?

Rescheduling cannabis would not necessarily result in full-blown legalization. For example, if the DEA were to relegate cannabis to a Schedule II classification, it would still be considered "highly addictive with a dangerous potential for abuse." [22] However, if designated as a Schedule II drug, cannabis would be considered "medically acceptable in particular cases, like for treating chronic pain or addiction." [23] Rescheduling in this way would have virtually no effect on the recreational status of cannabis because recreational possession and use would still be "illegal" and subject to prosecution under the Controlled Substances Act.

WHAT IT WOULD DO

The Brookings Institute notes, "There are fewer obstacles to conducting research on drugs in Schedule II for research than Schedule I" and that rescheduling cannabis as Schedule II would "slightly relax the bureaucratic hurdles to research on the medical benefits or impacts of cannabis." (24) Additionally, rescheduling would permit FDA-approved derivatives of cannabis to be available for "prescription with the highest level of restrictions." (25) Beyond opening opportunities for medical research, reclassifying cannabis would send a message to the medical research community, state policymakers, and constituents that the federal government supports further research for legitimate medical marijuana use, which cannot be said of its current Schedule I designation.

THE POT PARADOX

One might imagine that pro-cannabis groups would advocate for the rescheduling or even de-scheduling entirely of cannabis. However, some states that have already developed robust cannabis industries now have market incumbents that fear moving cannabis to Schedule II would open the market to large tobacco and/or pharmaceutical companies that would be eager to pursue the now more-legitimized medical research angle. (26) And while de-scheduling cannabis would effectively legalize it across the country, it would make it even more likely that an influx of tobacco and pharmaceutical companies would flood the market. If federal lawmakers did push for rescheduling or de-scheduling cannabis, they may very well receive push-back from progressive cannabis states with well-established cannabis industries. Because there is disagreement about the best path forward among the cannabis-legalization community, a change in the scheduling of marijuana under the Controlled Substances Act is unlikely in the near-term.

FEDS STILL SAY 'CAN'T' ON CANNABIS

Simply understanding the state and local legal landscapes for marijuana cultivation, use, and sale across the country is a challenge. Further complicating matters is that even in a state that has legalized or decriminalized the possession and distribution of marijuana, it remains illegal under federal law. (27) This fact has caused many to eye the proliferation of a legalized marijuana industry with caution, hesitation, confusion, and skepticism.

Recent developments at the federal level have only added to the confusion. After several states passed legalization bills, Deputy Attorney General James Cole released in August 2013 a Department of Justice memorandum issuing guidance to federal prosecutors concerning marijuana enforcement under the CSA. The guidance suggested that federal prosecutors and law enforcement officials prosecute based on the state's specific medical and recreational marijuana laws with the expectation that "states and local governments that have enacted laws authorizing marijuana-related conduct will implement

strong and effective regulatory and enforcement systems that will address the threat those state laws could pose to public safety, public health, and other law enforcement interests." [28]

The Cole memo offered some reassurance to those individuals and businesses involved with the marijuana supply chain that they would not be prosecuted under federal law for activities in states that allow the production, and distribution, and use of marijuana. However, this reassurance came only in the form of a guidance memorandum, which can be retracted at any moment.

The outcome of the 2016 presidential election eradicated any perceived stability in the "legality" of the cannabis industry. With a new administration at the helm, those involved in the marijuana business expressed concerns about the status of the DOJ's prosecutorial discretion under the Cole memo. Their fears were realized when, in January 2018, Attorney General Jeff Sessions released a memo directing U.S. attorneys to "enforce the laws enacted by Congress and to follow well-established principles when pursuing prosecutions related to marijuana activities." [29] The Sessions memo heightened the confusion about the legal status of the cannabis industry, even in those states that had legalized it under their own laws. The DOJ's reversal has come close to bringing the conflict between state and federal marijuana laws to a head.

THE BANK SECRECY ACT

Passed by Congress in 1970, The Currency and Foreign Transactions Reporting Act of 1970, commonly referred to as the Bank Secrecy Act or "BSA," requires U.S. financial institutions to assist U.S. government agencies in detecting and preventing money laundering. Specifically, the act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and report suspicious activity that might signify money laundering, tax evasion, or other criminal activities." [30] Several other anti-money laundering laws, including provisions in Title III of the USA PATRIOT Act of 2001, have been enacted to amend the BSA.

These laws apply to marijuana due to its inclusion as a Schedule I controlled substance, with the highest severity for violations. When banks or other financial institutions engage in such commerce, they must report suspicious activity to FinCEN, the Financial Crimes Enforcement Network. Following guidance issued by FinCEN, financial services firms are permitted to submit special marijuana-related suspicious activity reports, or SARs. However, such firms are required to review more than 50 items of guidance for each transaction to ascertain if a potential violation of federal law beyond violating the CSA has occurred. The cost of compliance and the time it takes to analyze each transaction to avoid penalty tends to keep most banks out of even attempting compliance in this regard. [31] According to the Brookings Institute, only around 350 banks and credit unions do business with marijuana-related

operations. [32] Together, they file more than 2,000 SARs each month in order to comply with FinCEN's guidance. [33]

THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

The Racketeer Influenced and Corrupt Organizations Act broadly defines activities that would be considered "racketeering" to include dealing in controlled substances found in 18 U.S.C. §1961. It also makes it unlawful "for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt." [34] Additionally, there are not only criminal penalties (18 U.S.C. §1963) but civil penalties that can be prosecuted by the U.S. (18 U.S.C. §1964) and private citizens for any person injured in his business or property by reason of a violation.

The act was originally utilized for organized crime syndicates that crossed state lines and engaged in a number of illegal activities. However, RICO has been used to target a broad spectrum of industries and activities. For example, RICO has been discussed to combat alleged collusive pricing among health care networks. Other lawsuits have been brought founded upon nuisance or reputational or property value loss simply for being associated with various entities.

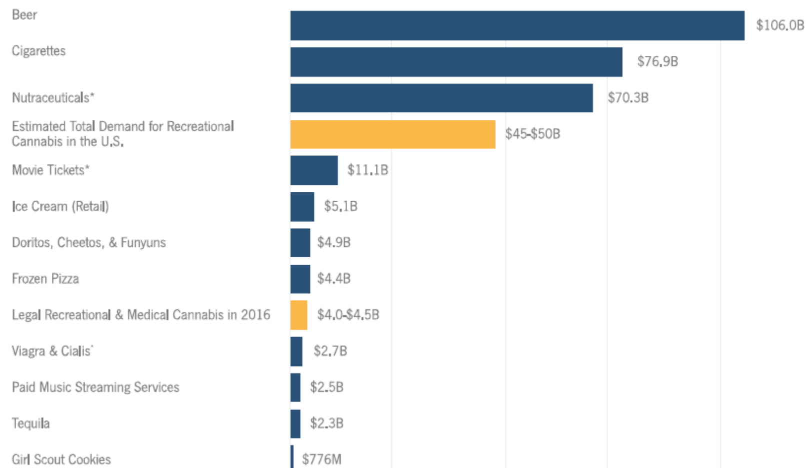
In the cannabis context, in a recent case a federal judge held that private landowners could bring civil claims under RICO against marijuana growers and their associates alleging an injury to their land. [35] The plaintiffs claimed the racketeering activity the defendants engaged in (although legal by Colorado state law) was the "dealing in marijuana," and the marijuana growing operation injured their property by "emitting pungent, foul odors, attracting undesirable visitors, increasing criminal activity, increasing traffic, and driving down property values." [36]

A GROWING INDUSTRY, DESPITE DIFFICULTIES

The confusion and potential criminal exposure resulting from marijuana's legal status under federal law extends well beyond those individuals or businesses directly involved in the supply chain. In particular, companies providing ancillary services, such as banking or insurance services, to a state-legalized marijuana industry can be exposed to legal issues. In addition to violating the Controlled Substances Act, doing business with any part of the marijuana industry can run afoul of several federal laws, including the Banking Secrecy Act/Anti-Money Laundering Law and the Racketeer Influenced and Corrupt Organizations Act. Banks and insurers providing services to enterprises involved in the cannabis industry could find themselves held criminally or civilly liable for allegedly causing harm to others by aiding the operation of the business.

For these reasons, many industries have avoided doing business with anyone involved in the cannabis supply chain. This has created difficulties for marijuana-related businesses in obtaining basic services such as banking and insurance. Despite this, those states that have legalized marijuana to some degree have seen an entire industry spring up with the cultivation and sale of marijuana becoming a booming business. In 2017, the legal medical and adult-use market reached $8.5 billion, according to the "State of Legal Marijuana Markets" executive report. The same report projects that the U.S. cannabis market will reach $23.4 billion by 2022. (37) Another report even likened the industry's 25 percent compound growth rate through 2021 to cable television at 19 percent in the 1990s and broadband internet at 29 percent in the 2000s. (38) Other reports project the industry would reach as much as $50 billion by 2026 if marijuana were legalized at the federal level. (39) In addition, medical and adult use retail cannabis tax revenues topped $745 million in 2017 and are expected to hit $2.3 billion in 2020. (40)

ANNUAL U.S. CANNABIS SALES VS. OTHER INDUSTRIES & GOODS [41]



* Includes U.S. and Canada
Source: Brewers Association, IRI, Mordor Intelligence, MPAA, Statista, Eli Lilly and Company, Pfizer, RIAA, U.S. Distilled Spirits Council,
Note: All data is for 2015 or 2016, most recent figures are reported in the chart.
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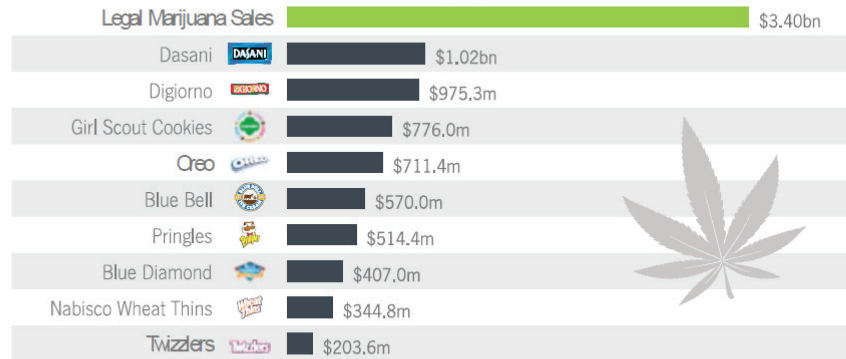
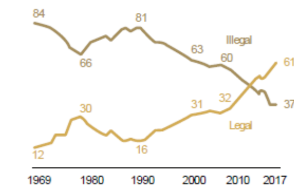


Public support for the legalization of marijuana has been steadily growing. When Gallup first surveyed Americans about marijuana use in 1969, only 12 percent of those surveyed supported legalization.(43) In an October 2017 Gallup Poll, 64 percent of participants indicated they believe that the use of marijuana should be made legal. In a study conducted by New Frontier Data in 2017, 63 percent of participants agreed that "The federal government should legalize cannabis." Fifty-five percent of participants indicated that "cannabis should be legalized, regulated, and taxed like cigarettes and alcohol" while only 9 percent suggested that "cannabis should be illegal." (44) According to a January 2018 Pew Research study, six in 10 Americans say that the use of marijuana should be legalized. (45) Pew's study also underlines the generational disparities on the issue of marijuana legalization: 70 percent of millennials, 66 percent of Gen Xers, and 56 percent of baby boomers say the use of marijuana should be legal. In a poll conducted by Quinnipiac University in 2018, 63 percent of Americans supported legalizing marijuana, the highest number ever measured in a series of successive polls. (46) In the same poll, 93 percent of participants supported the use of medical marijuana. (47)

U.S. public opinion on legalizing marijuana, 1969-2017

Do you think the use of marijuana should be made legal, or not? (%)



%who say marijuana should be made legal

Note: Don't know responses not shown. 1973-2006 data from General Social Survey. 1969 and 1972 data from Gallup.
Source: Survey of U.S. adults conducted Oct. 25-30, 2017.

PEW RESEARCH CENTER

INTERSECTION OF CANNABIS AND PROPERTY/CASUALTY INSURANCE

Even if no other states passed legalization laws and the industry stopped growing – a dubious proposition indeed – insurance companies have been, and will continue to be, affected by the presence of marijuana for sale and for medical and recreational use across the states where it has been legalized. The industry and its regulators are increasingly recognizing this fact. For example, the National Association of Insurance Commissioners in August 2018 created the Cannabis Working Group to study cannabis issues affecting the insurance industry. (48) A brief consideration of just a few sample lines of business will serve to illustrate some of the interconnections.

HOMEOWNERS INSURANCE

The interconnectedness of cannabis and insurance can be clearly seen through some of the issues that have arisen with the homeowners line of insurance. A common question growers and users are asking is whether marijuana and related products would qualify as property covered by homeowners insurance policies if they are stolen or damaged. The answer is complicated. A court case from Hawaii serves as an illustrative case. In July 2010, 12 of Barbara Tracy's marijuana plants were stolen from her property. Tracy, a resident of Hawaii, filed a claim, and her carrier offered her a settlement of $8,800. (49) Tracy rejected the settlement and asked for more money plus bad faith damages totaling $45,000. Her carrier contested the claim, arguing there was no valid insurable interest in the plants because of a statute that says you can only have insurable interest in a lawful substance. (50) Given that marijuana

is illegal under the CSA, Tracy's carrier argued that it would be defying public policy if the court mandated the policy cover the plants. (51) In the end, the court sided with the carrier and rejected Tracy's claim. However, as several other cases described below demonstrate, the results of these types of cases can depend on whether the judge rules that the CSA or state laws legalizing the substance are the controlling law.

The prior case demonstrates a key general principle when dealing with cannabis and insurance. Basic contractual law holds that parties can contract for any matter that is considered legal. An "illegal" contract can be determined to be void ab initio or "from the beginning." Due to the various scenarios that can arise between the policyholder, the insurer, and other third parties, the need to exclude or disclaim liability after a policy is in effect is a real consideration that must be understood and defended accordingly if an insurer so chooses. This in turn creates other coverage decisions, including the duty to defend and indemnify that can result in additional declaratory rulings from courts. Further, issues concerning timely and accurate disclosures as to coverage or risk, underwriting clarity and nvestigation, risk management of entities, cooperation with an insurer, and lack of candor all play into coverage decisions that can result in litigation.

Another critical question is how an insurance company will know if a policyholder is growing marijuana and what that ultimately does to its risk profile, regardless of whether the company intends to cover any of the grow apparatus or the product. In other words, this could be a risk factor over-and-above what it might cost to insure the marijuana itself. Many homes' electrical systems are not equipped to handle the kind of power required to operate an in-home grow and more inexperienced growers and manufacturers will not always take the necessary steps to create the safest possible environment for growing inside the home. Insurance companies may find that their homeowners policies in states that are decriminalizing and legalizing marijuana may need to address the risk factors of growing marijuana. Grow operations may present more risk to a home due to the nature of growing the plant, and insurers may want to attempt to ascertain if this additional risk factor is present when underwriting a homeowners insurance policy.

Another key issue for both homeowners and commercial property insurers to understand is the potential dispute over classifying property as commercial or personal. In a Colorado case, Weingarten v. Auto Owners Insurance Company, Connie and Edward Weingarten sued their insurer arguing the company had "denied their insurance claim which sought coverage for property damage due to an illegal marijuana grow operation." (52) Auto Owners sought summary judgement based on the fact that the property was not used "principally" as a residence but rather as an "illegal marijuana grow operation." The Weingartens provided photos of furniture, electronics, and other amenities to argue that the house was primarily used as a residence after initially admitting they used "virtually the entire house in this operation." (53) The judge denied summary

judgement to Auto-Owners "to the extent it sought a determination that the house was not used principally as a private residence."

COMMERCIAL PROPERTY

A commercial property insurer may have similar considerations as a home-owners insurer when it comes to the potential risk profile of a policyholder that may be operating a marijuana grow within the property. Businesses that establish commercial- scale marijuana grow facilities represent fire risk substantially due to the complex apparatus and electric configurations required to safely grow and maintain marijuana. These businesses also have a very high-risk profile when it comes to theft. Noah Stokes, founder and CEO of OmniGuard Security, a marijuana security business, observed, "I've never met anybody who grows marijuana who's not been robbed; not just robbed once, but robbed multiple times." (54)

As in the case of homeowners insurers, in states that are decriminalizing and legalizing marijuana, companies may want to know for certain whether any part of the commercial property being insured is being used by a marijuana-related business. Similarly, landlords and insurers of landlords can become involved in cannabis issues/claims inadvertently. The increased costs involved in insuring cannabis operations put a higher burden on underwriters to understand their insureds and the potential for cannabis-related tenants/businesses to increase the risks at insureds' rental properties. In addition, the historic use and rental of an insured property can increase insurer exposure. As in environmental claims, underwriters might benefit by inquiring about the historic use of insured properties to avoid being brought into litigation along with prior carriers for an insured even if the cannabis risk is no longer at the property.

To the extent that a property is known to house such a business and coverage is offered anyway, marijuana's classification as a Schedule I drug may not be a valid reason for denying payment of a claim. The case of Green Earth Wellness Center v. Atain Specialty Insurance Company involved a claim filed by Green Earth in 2013 after "thieves entered Green Earth's grow facility through a roof vent and stole various plants." (55) Atain denied the claim on the grounds that marijuana is illegal at the federal level even though it knowingly provided Green Earth with general liability and commercial property policies for marijuana plants. (56)

Green Earth subsequently sued for breach of contract, bad faith, and unreasonable delay in payment. The district court eventually ruled that Colorado laws governed the contract, not federal laws. (57) Atain, having entered into the contract knowing that Green Earth was a marijuana business, could not invoke federal illegality of marijuana as a reason not to pay in this case. (58)

Property risks associated with cannabis can include the loss or damage of the product, fire damage, theft, and damage to the building itself. [59] Ultimately, insurance companies, particularly those with businesses in states with medical or adult-use marijuana laws on the books, should be aware of what is and what is not potentially covered by a specific property policy with regard to marijuana.

AUTO

Some reports suggest that highway safety has already been affected by the surge of cannabis legalization across the country. A 2018 Governors Safety Highway Administration study found that marijuana is the most common drug found in fatally injured drivers and marijuana presence has increased substantially in the past decade. [60] One recent Insurance Institute for Highway Safety (IIHS) study "examined 2012-16 police-reported crashes before and after retail sales began in Colorado, Oregon and Washington" which estimates "that the three states combined saw a 5.2 percent increase in the rate of crashes per million vehicle registrations, compared with neighboring states that didn't legalize marijuana sales." [61] Additionally, an October 2018 Status Report produced by the IIHS and the Highway Loss Data Institute (HLDI) noted, "HLDI analysts estimate that the frequency of collision claims per insured vehicle year rose a combined 6 percent following the start of retail sales of recreational marijuana in Colorado, Nevada, Oregon and Washington, compared with the control states of Idaho, Montana, Utah and Wyoming." [62] IIHS-HLDI President David Harkey has recently noted, "Despite the difficulty of isolating the specific effects of marijuana impairment on crash risk, the evidence is growing that legalizing its use increases crashes." [63]

The IIHS and HLDI also identify other potential challenges related to marijuana intoxication and sobriety testing. Their 2017 Status Report cites, "unlike alcohol, experts don't agree on how much marijuana must be consumed for a driver to be impaired. [Additionally] A positive test for THC and its active metabolite does not mean the driver was impaired at the time of the crash." [64] In theory, a driver could be completely sober yet test positive for marijuana that was consumed weeks before the test. The lack of a reliable impairment test for marijuana could prevent law enforcement from identifying impaired drivers and prevent insurers from understanding an insured's true risk profile as they can with an alcohol-related DUI on a driving record.

Relatedly, it is not clear that users of marijuana know how much or whether certain kinds of consumption will lead to impairment. As Chris Cochran, spokesperson for California's Office of Traffic Safety asserted, "With the higher prevalence of marijuana in the world, what we're seeing is a sort of denial of the fact that marijuana can be impairing … Marijuana is not a benign substance when it comes to driving ability. It throws off your perception of time, loosens inhibitions, and changes reaction times." [65] If drivers do not under-

stand or have a clear way of measuring their own impairment or risk potential, driving in states with high levels of marijuana use could pose greater risk to fellow drivers and stymie efforts to combat impaired driving.

Another consideration is personal injury protection coverage, also known as "no-fault" insurance coverage. These policies pay claims for incurred medical expenses regardless of fault (as well as lost wages in some states) for injury and property damage because of an auto loss or accident. Reimbursement for injuries can arise that may include a duty to reimburse for prescribed cannabis because of a motor vehicle collision. On the other hand, some states, such as Michigan, have contained within their PIP statutes a ban on cannabis reimbursement. The statute states "[a]n insurer shall not be required to provide coverage for the medical use of marihuana or for expenses related to the medical use of marihuana." (66) A close review of state law and policy coverage in any given state is needed to truly understand coverage exposures.

Companies offering commercial auto may also be impacted by the marijuana industry. Transportation in the industry entails carrying large and expensive quantities of cannabis product(s), in addition to thousands of dollars in cash due to the lack of available banking services as discussed above. This situation presents an enormous amount of risk. Commercial auto insurers will want to work closely with any transportation or shipping company policyholders to understand if and how someone might ship marijuana using their service and how that will impact their risk profiles as potential distributors.

WORKERS' COMPENSATION

Workers' compensation insurers generally have had to deal with the complexities, confusion, and potential impact of the rise of marijuana legalization. One significant question is whether workers' compensation should cover medical marijuana if it is prescribed to the patient by a physician. Currently five states – Connecticut, Maine, Minnesota, New Jersey, and New Mexico - have laws requiring medical treatment reimbursement for marijuana under workers' compensation laws, according to the National Council for Compensation Insurance.(67) Despite state law, some courts have ruled that the federal Schedule I drug classification under the Controlled Substances Act preempts state law, and Florida and North Dakota have passed laws that exclude marijuana treatment from workers' compensation reimbursement. (68)

A case that illustrates the complex and changing legal landscape for workers' compensation insurance and medical marijuana is Gaetan H. Bourgoin V. Twin Rivers Paper Company, LLC. In the 1980s Bourgoin of Maine, sustained a work-related back injury while working at Twin Rivers Paper Mill. Bourgoin was initially prescribed opioids in various forms until the side effects produced adverse health effects. As a result, Bourgoin's physician issued him a medical marijuana certification to manage his chronic back pain. (69) The Maine's Workers' Compensation Board ruled that Twin Rivers' insurer must reimburse Bourgoin for his medical marijuana. (70) However, Twin Rivers con-

tested Bourgoin's successful petition citing that CSA "barred" reimbursement despite Maine's Medical Use of Marijuana Act.[71] Following an unsuccessful appeal to the appellate division, Twin Rivers' petition for appellate review was granted by the Maine Supreme Court. [72]

The Maine Supreme Court later held that there was a, "positive conflict between federal and state law" and that the CSA preempts the state's MMUMA law. [73] Maine Supreme Court Associate Justice Jeffrey Hjelm stated, "Prosecuted or not, the fact remains that Twin Rivers would be forced to commit a federal crime if it complied with the directive of the Workers' Compensation Board." [74] Hjelm contended that Twin Rivers could not simultaneously comply with both federal and state laws, but that according to the CSA, Two Rivers would be "aiding and abetting Bourgoin in his purchase, possession and use of marijuana," and therefore breaking federal law. [75]

The Bourgoin case demonstrates that in some instances state laws can be preempted by the CSA, but this is not always the case. In Vialpando v. Ben's Automotive Services and Redwood Fire & Casualty, a New Mexico case from 2014, an injured worker's employer cited the CSA and asserted that it would be illegal under federal law to reimburse the employee for medical marijuana. [76] New Mexico's intermediate appellate court determined that "an employer and its workers' compensation carrier are required to reimburse an employee for costs associated with the purchase of medical marijuana." [77] The juxtaposition of the two cases illustrates the ambiguity that is created given conflicting state and federal marijuana laws. This state of affairs led NCCI to predict, "For the foreseeable future, the marijuana landscape will likely remain a state-by-state patchwork with courts being actively engaged in interpreting the law." [78]

As in the auto insurance space, marijuana use has created a perplexing landscape for employers, employees, and insurers when it comes to workers' compensation. Since testing for accurate marijuana intoxication levels is more challenging than for alcohol, it may be difficult to determine if employees who have sustained an injury on the job were under the influence of marijuana at the time of the injury. If that is so determined (the determination likely to be challenged given the above), depending on state law and company policy, it may be the case that workers' compensation will not be available. If the company established a "no drug-use policy," the employee filing a claim in this case may have an issue. These are just a few of the many intricacies pertaining to workers' compensation that insurance companies and policyholders have experienced during the trend of state-based legalization of marijuana across the U.S.

From a different perspective, there has been a growing number of people suggesting that marijuana may be a viable alternative to opioids for pain relief in certain instances. [79] Injured workers prescribed opioids for pain relief are at risk of becoming addicted, which can be counterproductive to one of the central missions of workers' compensation insurers: helping injured workers return to

work. In light of the opioid epidemic, if marijuana proved to be an adequate alternative without the potential for addiction, it may be a preferable option. However, the assertion that it is a preferable alternative remains highly controversial, and there has not been a substantial amount of research into the long-term effects of marijuana usage based on either quantity or form. Additionally, a workers' compensation insurer may be paying for marijuana for an extended period until a doctor says it is no longer needed. There could also be the potential treatment of any side effects or other issues that occur from long-term cannabis use, such as mental health treatment for paranoia for example, that may be compensable as well. Workers' compensation insurers will want to carefully follow the scientific research on cannabis and its derivatives like cannabidiol to better understand its medical efficacy and effects.

It is imperative for workers' compensation insurance companies with business spanning across the 30 states that have now legalized medical and/or recreational marijuana to closely monitor the shifting legal status of medical marijuana to better understand the conditions that prompt and require reimbursement for medical marijuana, at the very least under state law. At present, even with more lenient state laws, the combination of the Schedule I classification and local courts' interpretation, it is a difficult space to navigate. This is even more true for legalized states in which stakeholders along the cannabis supply chain cannot find coverage in the private market and resort to the state's residual market mechanism, which in many cases is an assigned risk pool. If a company is required to offer coverage to a cannabusiness through a residual market mechanism, this will put the company between the proverbial rock and a hard place facing a serious and fundamental conflict between state and federal laws.

A FEDERAL SOLUTION?

There have been efforts at the federal level to eliminate or mitigate the conflict between state and federal laws as it pertains to marijuana. The Rohrabacher-Farr Amendment, signed into law in 2014 after facing six rejections, says that the Department of Justice and the Drug Enforcement Administration cannot use federal funds "to prevent states and territories from implementing their own laws on MMJ [medical marijuana]." [80] In theory, this would protect states with medical marijuana laws on the books to prevent federal government interference. This amendment, however, does not protect recreational marijuana laws or businesses. The bill has been renewed eight times since it first passed the House in 2014. [81] However, despite Rohrabacher-Farr, district courts have often ruled in favor of the CSA as the controlling statute in the cases before them, as several cases considered in this paper demonstrate.

On June 7, 2018, Sens. Cory Gardner, R-Colo., and Elizabeth Warren, D-Mass., introduced the Strengthening the Tenth Amendment Through Entrusting States, or STATES Act. The bill "would amend the existing Controlled Substanc-

es Act to say it no longer applies to those following state, territory or tribal laws relating to the manufacture, production, possession, distribution, dispensation, administration or delivery of marijuana." [82] In essence, the STATES Act is aimed at ensuring that states' marijuana laws are respected by the federal government and not preempted by the CSA.

CANNABUSINESS: A POTENTIAL MARKET FOR PROPERTY/CASUALTY INSURERS?

Already a $9 billion industry in 2017, it is estimated that the cannabis business will account for more than 280,000 jobs in the agriculture, manufacturing, management, administration, and retail operations industries by 2020. [83] With investors pouring $500 million into privately held cannabis companies in 2017, it is likely that investment and jobs in the cannabis supply chain will only become more common in the coming years.[84] While those dealing directly with the plant/product (see Appendix I for full description of the cannabusiness supply chain) are the primary players in the burgeoning marijuana industry, there are countless other professions associated directly or indirectly with the plant: legal counsels, compliance officers, wholesale buyers, transportation services, web developers, sales representatives, and security guards for growing facilities. As the industry continues to develop it will continue to more closely resemble traditional industries in its need for various products and services – including insurance products and services.

Due to the complicated legal landscape described above, there are very few admitted property/casualty insurers active in the marijuana space, despite the fact that virtually every leg of the cannabis supply chain has a need for insurance products and services. Many in the marijuana industry have complained about the lack of insurance products available to growers, processors, and distributors. Due to the general reluctance of insurers to write policies for cannabis suppliers and products, some larger cannabis operations have considered establishing captive insurers in order to cover their specific insurance needs while others have looked to surplus lines carriers for needed coverage. [85] Some admitted carriers have begun exploring the space: in California in 2017, Golden Bear Insurance Company became the first admitted carrier to offer insurance policies for cannabusinesses. [86]

If the legal status of marijuana is resolved to eliminate the conflict between state and federal laws, more insurers may show interest in exploring engagement with cannabusinesses in a variety of ways. A few examples include:

> Both commercial property and personal homeowners insurance face many similar risks and, consequently, similar potential associated with growing, manufacturing, distribution, and possession of marijuana. As state laws increasingly sanction small, in-home growing and commercial sale for medicinal and adult-use, there is certainly

- a role for more commercial and homeowners insurers to play in ensuring that policies are offered that reflect the heightened risks associated with cultivating, processing, distributing, and consuming marijuana.
- Within the commercial auto space, armored car coverage is carving out a place for itself in the industry. According to Todd Kleperis, CEO of Hardcar Security, a recreational and medical marijuana transportation company, "You become a huge target [for criminals] and your risk profile is off the charts" when you are involved with moving marijuana products. (87) Kleperis's unique business "operates more like a military operation than a transport company," deploying unmarked trucks, often driven by armed military veterans. (88) High-risk policies for marijuana transportation companies such as Hardcar could be offered to further protect the players in the marijuana supply chain.
- Given all the businesses involved in the marijuana supply chain, the growth of cannabusiness will require more workers' compensation coverage. Cannabusinesses understand the many risks that accompany marijuana growing, manufacturing, and distribution have also created a demand for workers' compensation policies that will cover their employees in the event of a workplace accident.
- Indoor and outdoor crop insurance represents perhaps one of the most lucrative yet risky markets for property/ casualty insurers. An acre of marijuana can produce more than $1.1 million worth of revenue – to put that in perspective, an acre of corn typically yields about $645 worth of crop. (89) Farmers are looking to marijuana to diversify their crops and ultimately make a generous profit that cannot always be made with commodity grains. Farmers who have been growing marijuana crops have also noticed a coverage gap and have voiced their interest in cannabis crop insurance. (90)
- Another line of insurance that will be affected by the growth of the cannabis industry is product liability insurance. Cannabusinesses have expressed a need for product liability insurance in case the product is defective and causes bodily harm or injury to a customer or a client. According to the law firm Wilson Elser, "From September 08, 2015, through April 26, 2017, Colorado authorities reported 66 cannabis recalls," which highlights an industry that is still learning how to harness and master the science behind the product. (92) Given that the physical composition of cannabis products can vary, consisting of different ingredients, doses, and pesticides, cannabusinesses have articulated a need for product liability insurance products. In particular, edible products may be significantly more potent than other forms of cannabis and clients may not realize that several bites may cause a longer and more intense effect than a small bite. If a customer falls ill from consuming a product – even if it was consumed incorrectly – liability exposure could apply up the supply chain. (93)

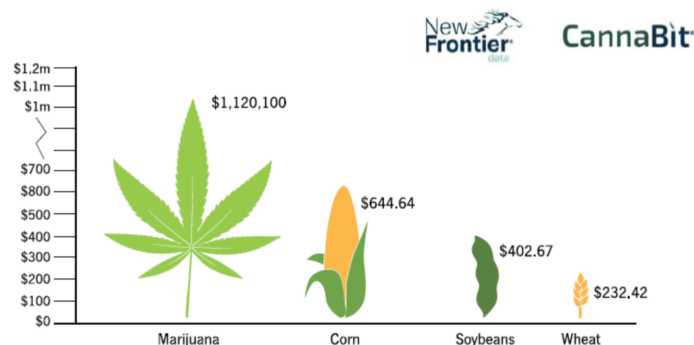
- Like most retail stores, marijuana retail dispensaries also need commercial general liability coverage for any customer-related accidents or injuries that may occur on the premises. For example, California requires distributors to "carry and maintain commercial general liability insurance in the aggregate in an amount of no less than $2,000,000 and in an amount no less than $1,000,000 for each loss." [94] Demand for CGL policies from dispensaries and other cannabusinesses within the marijuana supply chain, especially those with frequent day-to-day interactions with customers in a retail store, may create a robust market.

- Analysts have predicted strong potential markets for other commercial lines products, including but not limited to professional liability (E&O and D&O) and intellectual property coverages. [95]

Growers, processors, landlords, distributers, and physicians in states that have decriminalized and legalized marijuana have articulated a litany of coverage gaps that could be addressed by property/casualty insurers. Admitted carrier cannabis coverage is almost nonexistent, and this lack of insurance has created a surge in the surplus lines and captive insurance markets. The emergence of admitted carriers such as Golden Bear Insurance Company in California suggests that some insurers are indeed trying to identify effective ways to collect data and write policies for personal and commercial cannabis lines.

Assuming some clarity is brought to the legal landscape surrounding cannabis and as cannabusinesses become more common, more property/casualty insurers may enter the market on an admitted basis. This process of integrating cannabusinesses with property/casualty insurance could be slow, but the cannabis industry could also offer a tremendous potential market for insurers to offer coverage to those involved throughout the supply chain.

COMPARATIVE YIELD PER ACRE FOR GRAINS AND MARIJUANA [91]



Sources: USDA, The Rand Corporation, Correspondence with Marijuana Cultivators in Oregon

CONCLUSION

It is understandable that the vast majority of insurance companies have hesitated to enter a market in an industry for which there is relatively little data, a patchwork regulatory environment, and plenty of legal ambiguity. Unless and until federal law is modified, it could be a very long time before major carriers move into the cannabis space. However, current public opinion combined with widespread state and local efforts to legalize cannabis signifies a shift toward broader acceptance of marijuana for medical and adult recreational use. The existing marijuana industry is robust and only expected to get bigger.

It is therefore critical for insurers to understand the industry, potential impacts, and nuanced legal developments at the local, state, and federal levels even if they do not choose to offer products in the cannabis market. As evidenced by court cases and tension between local, state, and federal laws, there are many ways in which property/casualty insurers can become involved and impacted at the various stages of the marijuana supply chain. As Sen. Cory Gardner of Colorado has put it regarding marijuana legalization, it is a "ketchup out of the bottle" issue. (96) Therefore, it is worthwhile for companies that do business in the 30 states and growing that have legalized medical and adult-use marijuana, to at the very least, understand the multi- faceted impacts that cannabis can have on the property/casualty insurance industry.

APPENDIX I. UNDERSTANDING CANNABUSINESS & THE SUPPLY CHAIN

The cultivation and sale of marijuana today are a far cry from the one-man-show, garage-based grow operations that existed prior to formal recreational and medical legalization in numerous states. Those communities that have legalized it to some degree have seen the growth of a full-fledged industry, with a robust and multi-faceted workforce. According to the North American Marijuana Index that tracks the leading stocks operating in the legal cannabis industry in the U.S. and Canada, the cannabusiness industry can be segmented into three parts:

- Touching the Plant (cultivators, biotechnology, retailers)
- Direct Support (branding, lab testing, real estate, banking)
- Ancillary Services (investing & financing and technology and media) (97)

TOUCHING THE PLANT

Cultivators, or growers, make up the first stage of the marijuana supply chain. Cultivators are generally the individuals tasked with harvesting marijuana until it is ready for distribution to a lab for testing, a manufacturing center to be packaged, or a dispensary for immediate sale. The harvesting of marijuana comes with a variety of challenges ranging from the need for sensitive climate controls and protection against pest infestations, to risk of theft and improper handling during the growing process. Of the many elements of the marijuana industry, cultivators have seen the greatest influx of competition and face the most stringent regulatory hurdles that make earning a profit difficult, especially in the early stages of business development. In California, growers who have applied for state and local licenses must cease growing and manufacturing operations until they are cleared by state and local regulators. This process can take up to one year, and for small operations with very little capital the lack of cash flow can be devastating, ultimately pushing out the smaller competitors.

Processors are tasked with trimming, cutting, extracting, infusing, packaging, and a variety of other services involving refinement of the cannabis plant. Using a range of technology to prepare the product for sale, processors create finished products ranging from cannabis oils to edibles. [98] Processors face a number of work-related hazards depending on their specific refinement task(s) from exposure to chemicals, "compressed gases, flammable solvents, screening and pressing, and dry ice" according to the Washington State Department of Labor and Industries. [99] Processing is no doubt a dangerous aspect of the cannabis supply chain, yet an instrumental step in transforming the marijuana plant into a consumable product that reaches the market for both recreational and medicinal consumption.

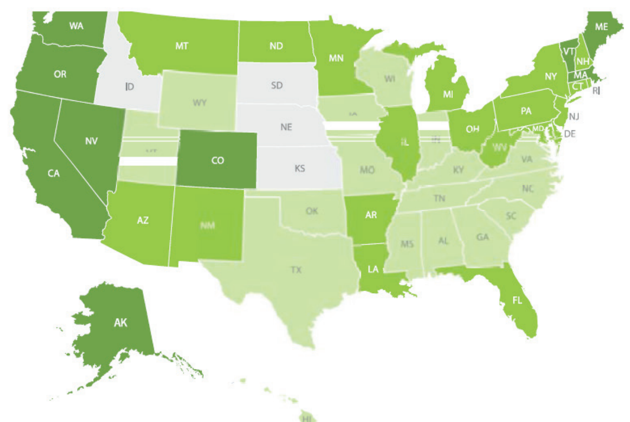
The Biotechnology sector consists of pharmaceutical companies primarily tasked with the research and development of drugs and products that contain active compounds in marijuana. [100] The Marijuana Index notes that the biotech sector "is currently the largest sector in the U.S. and is expected to continue its growth as more companies, universities, and governments around the world expand their research of cannabinoids, the endocannabinoid system, cannabis medicinal products, and more." [101] Companies such as Earth Science Tech and Cannabis Science Inc. are participating in research into and the development of cannabidiol, or CBD, products for therapeutic treatment of cancer and other ailments. CBD is a compound found in the cannabis plant that is typically used as an oil, gel, or supplement to treat seizures, depression, anxiety, and a host of other conditions. [102] Most importantly, CBD does not create the same "high" that THC does in various marijuana products. Biotech marijuana products, such as those refined by Earth Science Tech, are more widely accessible because 46 states now have CBD product laws. [103]

While the legal status of recreational use remains uncertain and volatile in many states due to conflict with the CSA, medical marijuana prescription is more widely accepted and regulated across the country and provides a booming niche for the biotech industry. For that reason, biotech companies tend to view marijuana through a bio-pharmaceutical lens and are steering clear of the recreational space. The goal of many biotech firms is to distribute their products through major retailers and stores, effectively reaching many more patients and providing treatment options for anxiety, depression, fatty liver disease, and other ailments. Partnerships with universities, investors, and other businesses are also being pursued to contribute to the legitimacy of these marijuana-related products and services. Biotechnology, with a stated goal of improving health, will no doubt remain an influential stakeholder in the industry as the commercialization of medical marijuana continues.

A dispensary is the final destination in the supply chain for marijuana after it has been cultivated, tested, refined if desired, and packaged. Dispensaries are essentially the retail stores that sell the finished marijuana product directly to consumers. Typically, dispensaries must apply for a state license to sell marijuana (often there are separate application processes for medical and recreational licenses) and comply with other state and local regulations before officially selling it. In the case of many medical dispensaries, customers with a valid medical ID register with the dispensary and make a cash donation since many dispensaries are set up as non-profits and due to banking complications cannot accept credit and depart the store with their product in hand. That is one example of how it might work, but state law regarding dispensaries varies significantly. [105] For example in Oregon in 2015, there were 269 medical marijuana dispensaries in operation – more than the number of McDonald's and Starbucks franchises in the state. [106] And that number has nearly doubled since. On the other hand, in Minnesota only permits a maximum of eight operating dispensaries at a time. [107] In states establishing stringent dispensary regulations like Minnesota, marijuana markets may become saturated quickly and offer less competition than Oregon, a state that offers plenty of opportunity for dispensary competition.

STATE CANNABIS PROGRAMS [104]

- NO MARIJUANA ACCESS LAW
- CBD & LOW-THC PRODUCT LAW
- COMPREHENSIVE MEDICAL MARIJUANA LAW
- ADULT & MEDICAL USE REGULATED LAWS



DIRECT SUPPORT

Testing labs are important components of the marijuana supply chain. Prior to the increase in legalization of marijuana for recreational and medical uses across a number of states, this leg of the supply chain really did not exist. For cultivators attempting to go unnoticed and yield the highest profit possible, sending their product to a testing lab understandably did not make much sense. Today, states that have legalized the use of marijuana typically require that product be tested by a lab before distribution to a dispensary and sale to the consumer. Labs use a variety of testing methods based on different products (oil, flour, gummi candies, etc.) in order to determine potency – the amount of THC, CBD, and pesticide concentrations in the product. (108) Patients with differing medical needs, often have prescriptions for specific strains and dosages of marijuana, and the labs testing the product play the role of ensuring that the product that reaches the market is the one desired by the consumer. Because of the variation in testing quality between states, customers "have a false sense that the product they are buying is actually what it says it is," according to a Forbes article published in 2017. (109) According to Dylan Hirsch, executive vice president of Diagnostic Lab Corporation, "There are lots of tests around, but no methodology of testing," which speaks to the great issue of standardization in testing that ultimately creates a system in which customers are forced to rely on the credibility and reputation of the grower, processor, and dispensary rather than an FDA-style of quality and product safety regulations. (110)

Real estate and land use play an essential yet complicated role in the cannabis industry. Cultivators, distributors, and dispensaries need space to grow, manufacture, and sell their product. Thus, homeowners and landlords can be involved in the industry without necessarily touching the plant or the finished drug. Because of the meticulous care and the potentially devastating mishaps that can occur with harvesting marijuana, landlords and sellers are charging top dollar for cannabusiness tenants and buyers. In fact, some who have retrofitted their homes to accommodate growers have received offers that are more than 100 percent above asking price. (111) While these sites that meet State requirements are more difficult to come by in states that have strict marijuana laws, in states experiencing the "green boom," there is real opportunity to see huge valuation in the marijuana real estate market. Due to tremendous variation between state laws, what may meet property and zoning requirements for cultivating or selling marijuana in one state may be completely different in another state. And it is also worth noting that landlords, especially those in states that authorize in-home growing and use, must be proactive in working with their tenants and subsequently with insurance companies to ensure that they understand the full risk profile of their home and property.

Banking entities are unique players in the marijuana industry. One of the most overwhelming challenges faced by cultivators and dispensaries is the significant lack of access to banking services (see above for detailed summaries of CSA, BSA, and RICO laws). To avoid breaking federal law and to stay clear of incurring money laundering charges, banks often decline business with potential cannabusiness clients despite state laws that have decriminalized or legalized cannabis. Even medical marijuana operations are largely unable to access banking services, requiring them to operate primarily on a cash basis.

Despite updated Financial Crimes Enforcement Network guidelines published in 2014 allowing banks to more actively engage in business with marijuana entities, most banks have decided not to pursue relationships with cannabusinesses. [(112)] Until marijuana's schedule classification is addressed by the president and Congress, the marijuana and banking relationship will likely remain in gridlock. As a result of limited banking opportunities, it is not uncommon for cannabusinesses to visit the IRS with thousands of dollars in cash to pay taxes. [(113)] While this micro-cash economy pervades throughout most cannabis markets, Washington state and Hawaii have been revamping their marijuana market financing schemes to include cashless payment options. [(114)] In the state of Washington, legal marijuana businesses must open bank accounts, and cannabusinesses in Hawaii use a payment system similar to PayPal, called CanPay. [(115)]

ANCILLARY SERVICES

Investing and Financing – According to the Marijuana Index, the investing and finance sector includes holding companies and financial service providers that manage portfolios of cannabis assets. [(116)] These companies are typically venture capital and private equity firms. The average investment placed in cannabis companies by venture capital firms is approximately $450,000, according to Forbes. [(117)] Firms have invested in a variety of businesses along the supply chain ranging from grow operations to companies that produce consumption devices.

Technology and Media organizations are other figures in the marijuana industry that fall under the ancillary services umbrella. The boom of the cannabusiness has created opportunity for an array of technologies such as seed-to-sale tracking systems, e-commerce platforms, specialized marijuana mapping technology, and devices that are used for consuming marijuana products. In addition, a number of marijuana-related media outlets such as High Times, Freedom Leaf, and Jane Street provide extensive reporting on all things marijuana.

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PwC NAIC Newsletter

December 2018

The National Association of Insurance Commissioners held its Fall National Meeting in San Francisco. This newsletter contains information on activities that occurred in some of the committees, task forces and working groups that met there and includes subsequent conference calls through December 19. For questions or comments concerning any of the items reported, please feel free to contact us at the address given on the last page.

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Executive Summary

- The Statutory Accounting Principles Working Group adopted SSAP 108, Derivatives Hedging Variable Annuity Guarantees, effective January 1, 2020 with early adoption permitted and finalized SSAP 86 guidance allowing the simplification of hedge effectiveness documentation. The working group also held a significant discussion on perceived risk transfer issues with YRT reinsurance on group life contracts and received industry comments on regulatory transactions and linked surplus notes.
- The Blanks Working Group adopted additional annual statement instructions and a Summary page for the significantly expanded Analysis of Operations and Analysis of Reserves schedules for year-end 2019 reporting.
- The Investment RBC Working Group continued discussion of the bond factors for all three RBC formulas, proposed to be implemented in 2020 RBC filings. The Life RBC Working Group continued progress on its Interpretation of 2018 Life Risk-Based Capital Results in Light of the 2017 Tax Cuts and Jobs Act document. The P/C RBC Working Group exposed for comment revised underwriting risk "line 4" factors for 2019 RBC filings.
- The Valuation of Securities Task Force deferred the effective date of the requirement to file private letter ratings from year-end 2018 to January 1, 2019 and postponed adoption of guidance related to eight classes of securities that the SVO has determined to be not eligible for filing exemptions.
- The Group Capital Calculation Working Group exposed for comment its draft field testing template; testing is expected to commence this spring.
- The Reinsurance Task Force adopted its proposed revisions to the credit for reinsurance models to reflect adoption of the U.S./EU Bilateral Agreement, but the Executive Committee deferred final action pending review of input received from the U.S Treasury and U.S. Trade Representative.
- The Life Actuarial Task Force adopted several significant Valuation Manual amendments, including removal of the 450% RBC threshold to qualify for a PBR exemption.
- The C-3 Phase II/AG 43 Subgroup exposed for comment draft sections of VM-21 on reserving for variable annuities to reflect recommendations from the VA Framework adopted this summer.
- The Financial Stability Task Force re-exposed documents on the scope and design element considerations of a possible liquidity stress testing framework for large life insurers.
- The Casualty Actuarial and Statistical Task Force continued its project to define what the minimum basic educational requirements are for the Appointed Actuary.

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December 2018

All documents referenced can be found on the NAIC website naic.org.

2018 mid-term elections

Seven governorships changed political parties from Republican to Democrat as a result of the mid-term elections: Illinois, Kansas, Maine, Michigan, Nevada, New Mexico and Wisconsin. The commissioner of insurance is an appointed position in all of these states except Kansas; as a result, at least six new commissioners will be appointed in 2019. This could result in a change in chairperson of some key NAIC committees in early 2019.

Executive Committee and Plenary

The NAIC elected the following officers for 2018: Superintendent Eric Cioppa (ME), President, Director Raymond Farmer (SC), President-Elect, Commissioner Gordon Ito (HI), Vice-President, and Director Dean Cameron (ID), Secretary-Treasurer.

During its meeting December 19, the commissioners approved the following:

- Amendments to Actuarial Guideline XLII—The Application of the Model Regulation Permitting the Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserve Liabilities (AG 42)
- Three new model acts/regulations: Limited Long-Term Care Insurance Model Act, Limited Long-Term Care Insurance Model Regulation, and Travel Insurance Model Act
- Bulletin Regarding Arbitration Clauses and Choice-of-Law/Venue

Innovation and Technology Task Force

Cybersecurity initiatives
The task force heard an update from Director Farmer of South Carolina, which is the first state to adopt the Insurance Data Security Model Law (#668). Enacting Model #668 remains a high priority for the NAIC and the director recommended that other states enact it promptly and as written to ensure uniformity in data security and breach legislation. The U.S. Treasury has endorsed Model #668; if other states do not adopt it, then Congress may pass legislation for uniform requirements for insurers.

In terms of federal legislation, NAIC staff provided an update and informed the task force that the Consumer Information Notification Requirement Act, which the NAIC opposed, passed the House Financial Services Committee. However, due to the changes in leadership in the Committee and the House of Representatives in 2019, any final bill may look quite different. The Treasury Department's Financial Banking and Information Infrastructure Committee, of which the NAIC is a member, has elevated cyber security to its primary area of focus.

State innovation and technology contacts
The NAIC has developed a webpage that provides state contacts for those who want to "discuss an innovative insurance product, service or technology and its regulatory implications."

Guest innovators
A significant part of the meeting was used to hear from guest innovators. The topics discussed included life insurance products that reward policyholders for choices that improve health and longevity, innovating renters insurance and increasing speed to market using a state's division of innovation and technology, where the product was discussed with regulators in the early stages before it was filed for approval.

Big data

Predictive models
Life underwriting - The Big Data Working Group discussed data accuracy and company validation methods in accelerated/non-traditional life insurance underwriting and whether regulators have sufficient tools to evaluate and validate the models and data used to predict mortality risk.

The working group discussed that models and data are often provided by companies that are not regulated by insurance departments, that the models might not provide the expected data, or that the output is only intended for one purpose, but could be used for another. Discussion also included challenges with assessing whether the data is accurate and how it's being used in the model. Interested parties discussed concerns such as the risk of the data being unintentionally unfairly discriminatory and stressed the need to take steps to identify and minimize this. Non-insurers such as InsurTechs who develop models would like the ability to submit the models for review by regulators. Discussion of these issues will continue in future meetings.

Property/casualty underwriting - The working group heard a report from the Casualty Actuarial and Statistical Task Force on their draft white paper on Regulatory Review on Predictive Models. The paper notes the benefits of the use of predictive analytics but also the challenges they pose for regulators that may not be equipped to review predictive models. The intent of the paper is to begin to outline a framework to provide consistency to the review and provide guidance for review of rate filings based on predictive models. The white paper has been exposed for comment until January 15, and includes discussion of best practices for regulators when reviewing predictive analytics, and the information the regulator may need to review the model, e.g. data sources for the model, type of data, etc.

Predictive modeling survey – The working group heard a report on a survey distributed in October regarding appropriate skills and resources required to conduct the review of predictive models; 51 jurisdictions responded. Preliminary survey results indicate great interest in "some type of electronic tool accessible by regulators containing information about which companies have filed models, what the variables are in those models, and what issues were identified by other states." A draft of the survey results is expected by the end of the year, with further discussion at the Spring National Meeting.

EU-U.S Insurance Dialogue Project
The goal of this project is to enhance the mutual understanding and cooperation between the EU and the U.S. focusing on three areas: 1) cybersecurity risk and the cyber insurance market, 2) the use of big data in the insurance sector and 3) group supervision. (The project participants are the European Commission, the European Insurance and Occupational Pensions Authority, the Federal Insurance Office and the NAIC.) A Big Data Issue Paper was recently released and is intended to provide a better understanding on the type, quality and means for collecting big data and how data is used by both insurers and third parties, and how U.S. and EU supervisors are addressing data needs to appropriately monitor the insurance marketplace.

Statutory Accounting Principles Working Group

Significant actions taken by the working group at the Fall National Meeting are summarized below. (Appendix A to this Newsletter summarizes all actions taken by the working group since the Summer National Meeting.)

SSAP 108 – Special accounting treatment for derivatives hedging VA contracts (#2016-03) – After almost three years of development and discussion, the working group adopted SSAP 108, Derivatives Hedging Variable Annuity Guarantees, and the related Issue Paper 159. The working group agreed to an effective date of January 1, 2020, with early adoption permitted as of January 1, 2019. Those companies with permitted practices related to hedging VAs are expected to retain those permitted practices for year-end 2018 financial statements.

The final standard will allow companies to use a form of "macro-hedging" of interest rate risk. All designated hedging instruments are reported at fair value. Fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the designated portion of the VM-21 reserve liability are recognized as deferred assets and deferred liabilities. The net deferred asset and liability from all hedging programs is transferred from unassigned funds to special surplus; the amortization timeframe equals the Macaulay duration of the guaranteed benefit cash flows based on the VM-21 Standard Scenario, but not to exceed 10 years. Fair value fluctuations in the hedging instruments that are not attributable to the hedged risk shall be recognized as unrealized gains or unrealized losses.

The standard has unique transition provisions: the guidance is to be applied on a prospective basis for qualifying hedge programs in place on or after the effective date, and prohibits deferred asset and deferred liability recognition from fair value fluctuations previously recognized as unrealized gains or losses that occurred prior to the effective date of the guidance. Companies with approved permitted or prescribed practices for qualifying hedge programs, which resulted in deferred assets and liabilities from unrecognized fair value fluctuations, shall work with their domiciliary regulator to determine the appropriate method in transitioning from previously approved permitted practices to the new guidance. At its meeting in San Francisco, the working group agreed to an ACLI-suggested change to allow a transition approach approved by the domiciliary regulator not to be considered a new permitted practice.

SSAP 86 - ASU 2017-12, Derivatives and Hedging (#2018-30) – The regulators approved amendments to SSAP 86 to adopt components of ASU 2017-12 which simplify the application of hedge accounting. The adopted guidance allows companies to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met and allows

more time to perform the initial quantitative hedge effectiveness assessment. The guidance is effective January 1, 2019 with early adoption permitted for year-end 2018. However, companies that prepare GAAP financial statements must adopt ASU 2017-12 for 2018 for GAAP reporting in order to early adopt the SSAP 86 revisions for statutory financial statements.

Reinsurance risk transfer (#2017-28) – At the Summer National Meeting, the working group exposed for comment proposed revisions to SSAP 61R and SSAP 62R, which had been developed by informal drafting groups focused on risk transfer and appropriate credit for reinsurance by the ceding company. The results of the discussion at the Fall National Meeting are below.

SSAP 61R - The working group received comments from both CT and NJ regulators who raised concerns about recent YRT reinsurance agreements of group life insurers with "excessive" YRT premiums which they believe should not be accounted for as reinsurance. The comments and proposed amendments to SSAP 61R proposed by CT and NJ will be forwarded to the life reinsurance informal drafting group for discussion. During the meeting in San Francisco, the New Jersey representative stated his view that revisions to SSAP 61R related to this issue should be made "as soon as possible with no grandfathering."

SSAP 62R – At the Fall National Meeting, the working group adopted proposed revisions to SSAP 62R effective January 1, 2019. Most of the changes add U.S. GAAP guidance from EITF 93-6 on retrospectively rated reinsurance contracts directly into the standard versus in corporation by reference.

Consideration of ASU 2016-13 - Credit Losses (#2016-20) – During the fall NAIC staff clarified that the intent of its discussion draft on consideration of ASU 2016-13 is to suggest for statutory accounting an approach for bonds similar to what is proposed for available-for-sale securities under the ASU, i.e. that losses would not be recognized until fair value is less than carrying value. The industry comment letter was submitted November 7, which includes the following statements:

> Interested parties note that ASU 2016-13's AFS debt securities impairment model is not substantively different than the current GAAP model as it pertains to the trigger and measurement of credit losses. As the current statutory impairment model is substantively aligned with current GAAP, we do not believe that the adoption of ASU 2016-13 for statutory accounting would be impactful to statutory surplus...Therefore, given that we would not expect any significant impacts to statutory surplus if the AFS impairment guidance of ASU 2016-13 were applied to the statutory accounting for bonds, we believe the costs associated with changing processes, systems, and statutory financial statements and exhibits outweigh any perceived benefits.

NAIC staff will be reviewing this comment letter in detail during the interim period, with additional discussion expected in early 2019.

SSAPs 2, 26R, 43R & 86 – Structured Notes (#2018-18) – The working group had proposed that structured notes (except for mortgage-referenced securities), for which contractual principal amounts are at risk for other reasons than failure of the borrower to repay, should be classified and accounted for as derivatives under SSAP 86 and valued at fair value. Based on feedback, the working group re-exposed the issue and asked for comments as to whether such structured notes should be accounted for as mandatory convertible bonds; on December 5, the working group exposed an additional document, which show examples of reporting such notes as a bond or forward contract.

The industry comment letter agreed with the use of fair value but objects to the treatment of the instrument as a derivative. Interested parties will do additional research with the intent of avoiding the unintended consequence of having instruments with immaterial amounts of "non-credit risk" being scoped into the new guidance.

SSAP 37 – Acquired Mortgage Loans (#2018-22) The first exposure in August sought to exclude ownership interests in a pool/fund of mortgages as SSAP 37 (Schedule B) mortgage loans. As a result of comments received, the working group believes more extensive revisions to the guidance adopted in 2017 related to participation agreements are necessary. The working group exposed comments to clarify that mortgage loans acquired through a participation agreement would be limited to a single mortgage loan agreement and would exclude "bundled" mortgage loans, e.g. acquiring interests in a bundle of mortgage loans with various unrelated borrowers and collateral.

SSAP 41R – Surplus Notes Linked to Other Structures (#2018-07) – At the Summer National Meeting, the SAP Working Group re-exposed for comment proposed revisions to SSAP 41R to

disallow capital treatment for surplus notes which are linked to other securities/structures that are not subordinate. There was no discussion of this topic in San Francisco as the comment period had been extended to after the Fall National Meeting.

In its November 30 comment letter, industry reiterated several key positions:

- Only "linked" surplus note transactions that attempt to circumvent regulatory approval of payments should be reclassified as debt.
- The broad definition of linked transactions in the current exposure draft would "materially impact existing financing structures, especially insurer captive structures," which are already subject to significant regulatory scrutiny.
- If SAPWG proceeds with the current exposure wording, it would need to be adopted prospectively with a future effective date to preserve financing cost assumptions built into premium.

The working group and industry will continue discussion of this issue in 2019.

SSAP 16R, ASU 2018-05, Customer's Accounting for the Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract (#2018-40) – The working group directed NAIC staff to draft revisions to SSAP 16R to adopt this new ASU with some modifications; it would allow companies to capitalize implementation costs as non-admitted non-operating systems software and to amortize the costs over a period not to exceed five years.

FASB guidance on long duration contracts - The working group briefly discussed ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts, noting that they anticipate rejecting the new standard. However, NAIC staff will be reviewing the guidance to assess whether any of the new disclosures from the standard should be incorporated into statutory accounting. See PwC's In depth white paper and video overview for further discussion of this new ASU.

SSAP 101 revisions as a result of tax reform – On December 11, the SAP Working Group industry interested parties group submitted a comment letter to the working group of their additional proposed changes to SSAP 101 and related Q&As, necessitated by the passage of the Tax Cuts and Jobs Act in 2017. Proposed changes focus on two areas: 1) necessary revisions to reflect the tax law changes, particularly in the Q&A's illustrative examples, and more substantively, 2) new clarifying guidance related to the issue of the reversal patterns of deferred tax items. The comment letter discusses what constitutes "scheduling," "detailed scheduling," or "additional detailed scheduling," and how "historical and/or currently available information" should be considered in the context of the DTA admission test under paragraph 11.c of SSAP 101. The working group anticipates holding a conference call in early 2019 to expose the documents for comment.

Blanks Working Group

Since the Summer National meeting, the working group adopted three proposals for year-end 2019, which are as follows:

- Provide additional instructions to the reformatted Life and Fraternal Analysis of Operations and Analysis of Reserves schedules and instructions adopted at the Summer National Meeting, beginning year-end 2019 (2018-22BWG).
- Add a Summary page to the revised Analysis of Operations page, which assists in reconciling the separate pages by product to the Summary of Operations page (page 4) (2018-26BWG). See the Financial Stability Task Force summary for additional discussion of the adopted "liquidity disclosures."
- Update the columns and rows on the Summary Investment Schedule to tie to the different investment schedules and the Assets page (2018-02BWG).

The working group also exposed 8 items for comment through March 6, which include the following:

- Add questions 34.1 and 34.2 to the general interrogatories part 2 of the Life annual statement, applicable to fraternals only. These questions were inadvertently left out of the 2018 annual statement when the fraternal blank was combined with the life blank (2018-23BWG).
- Revise the AVR Factors (basic contribution, reserve objective and maximum reserve) in the Life annual statement to be consistent with the RBC after-tax factors, which were amended in 2018 as a result of federal tax reform (2018-24BWG).

- Remove line 5, contract loans, from the separate accounts asset page to reflect the guidance under SSAP 56 that indicates all policy loans shall be reported in the general account. (2018-29BWG)

Risk-based capital

The regulators made the following significant progress on RBC projects. (Appendix B summarizes other actions taken by the various RBC Working Groups since the Summer National Meeting.)

Investment RBC

Bond factors – The RBC working groups continue to work towards 2020 as the implementation date for the bond granularity proposal (i.e. implementing 20 rating classes for RBC purposes versus the current 6 classes), after the chair of the Investment RBC Working Group announced at the Summer National Meeting that 2019 no longer appears feasible.

During its one meeting this fall, the Investment RBC Working Group continued its discussion of the proposed bond portfolio adjustment and assumptions in the Life bond factors. The ACLI continues to object the AAA proposed factors, noting that slope of the recommended factors is flatter compared to those of rating agencies. In addition, the ACLI still has concerns about the statutory reserve offset assumption in the bond factors. The AAA responses were as follows: the rationale for the flatter slope of the recommended factors is that the AAA model used recovery assumptions as opposed to default rates, due to rating agencies' shorter time horizon and their ability to change the rating of a bond. Changing the statutory reserve offset assumption, the AAA believes, would require reassessing all assumptions, including AVR and asset adequacy testing.

The working group also heard comments from interested parties on the AAA- proposed property/casualty and health bond factors. The AAA has recommended that a bond portfolio adjustment be included in the health formula, through the use of adjusting the proposed bond factors to reflect an average bond portfolio of health companies, versus the standalone portfolio adjustment used in the Life RBC formula. The Health RBC Working Group agrees with this recommendation. However, no changes to the factors, assumptions or models for any of the three formulas were agreed to or exposed for comment at the Fall National Meeting. The next meeting of the IRBC Working Group has not yet been scheduled.

Life RBC

Effect of tax reform on life RBC – This fall, the working group exposed for comment a document entitled Interpretation of 2018 Life Risk-Based Capital Results in Light of the 2017 Tax Cuts and Jobs Act. The communication is meant for regulators and other users of RBC to explain the changes to the formula so that users can distinguish between a change that is due to tax reform and a change due to something else. There appears to be general consensus that the estimate of the increase to required capital is between 5% and 15%, but some companies will be on either side of the range.

During its December 19 conference call the working group accepted in concept many of the proposed revisions suggested by the ACLI and also agreed that definitions of RBC ratio, Authorized Control Level and Total Adjusted Capital should be added to the document. The working group hopes to expose a revised draft for comment in early January with a conference call to adopt the communication by the end of January.

Longevity risk and mortality risk – There have been no updates from the AAA's Longevity Risk Task Force or the AAA's C-2 Work Group since the Summer National Meeting.

2019 Life RBC projects – During its December 13 call, the working group discussed two possible projects for consideration: updating the RBC charge for unaffiliated common stock when it supports long-horizon contractual commitments and the treatment of fixed-indexed annuities without living benefit riders. The working group expects a joint regulator (Illinois)/industry proposal on the common stock issue in early 2019.

Operational risk

Life RBC growth risk charge – The Operational Risk Subgroup continued discussion of developing a growth risk charge for the life formula, since unlike the P/C and health formulas, life RBC does not include a provision for growth risk. (The formula currently does include an informational growth risk calculation on LR029-A.)

During its August conference call, the subgroup approved exposure of a conceptual approach to an "enhanced add-on" method which would apply an additional RBC charge if triggered by significant growth year over year. During its October 30 call, the working group heard comments from the ACLI, the American Academy of Actuaries and United Healthcare, all of whom believe a separate growth risk charge is not necessary. The chair commented

that he still thinks this is an issue "worth pursuing," but that the project will probably be transitioned to the Life RBC Working Group when the Operational Risk Subgroup is disbanded in early 2019.

Health RBC growth risk charge - The Operational Risk Subgroup exposed for comment two proposed alternatives for measuring health RBC growth risk. The first option applies the current factor of 2% of premium revenue in excess of 25% of the prior year premium revenue but applies the result only to those insurers where membership has grown more than premium growth rate minus 10% (e.g. premium growth is 25% and membership growth is greater than or equal to 15%). The second option applies an escalating add-on factor (e.g. 1%, 1.5% and 2% of RBC after covariance) to those insurers that experienced membership growth of 20%- 50%; 51% and 100%; and >100% respectively. The subgroup will discuss comments on this proposal during its December 20 conference call.

P/C RBC

Underwriting risk – The P/C RBC Working Group exposed for comment until January 18 a new set of underwriting risk "line 4" factors (industry loss and expense RBC percentages), based on a study done by the AAA (proposal 2018-16-P). After significant discussion at the Fall National Meeting, the working group agreed to use the 35% capped factors for Commercial Insurance, Medical Professional Liability, and All Other Lines, and use uncapped factors for Personal Lines and Reinsurance Lines. Both the working group and industry support a 2019 effective date for the proposal.

Other catastrophe risks – After discussion at many meetings, the regulators reached a consensus that they should study whether wildfire risk should be included in catastrophe risk, in addition to hurricane and earthquake. The chair noted that the study could result in a conclusion that it is not necessary to include wildfire or any other additional catastrophe risks in the P/C formula.

Valuation of Securities Task Force

The task force has made progress on the following projects.

Private letter ratings

As a result of data issues related to filing private letter ratings via electronic feed from the rating agencies, the private letter rating filing requirement deadline was extended from December 31, 2018 to January 1, 2019. If private letter rated securities purchased after January 1, 2018 are not on the CRP data feeds beginning January 1, 2019, the securities will need to be filed with the SVO by insurers holding the security. For securities filed in 2018 and reported with a private rating in the SVO's data feed, they should be reported with a "PL" suffix; otherwise, companies should designate these securities as "FE" (not "Z") for year-end 2018 reporting.

P&P Manual amendment adoptions and exposures

MFE process elimination – The task force adopted a proposed amendment to eliminate the MFE process from the P&P manual. The SAP Working Group adopted similar amendments to SSAP 43R, which will result in conversion of CRP ratings for non-modeled loan and asset-back securities to NAIC designation without adjustment. The changes will be effective March 31, 2019, with early adoption permitted for year-end 2018 (early adoption must include all MFE securities). To address an issue raised by a large global insurer, the task force directed the Structured Securities Group to investigate expanding modeling coverage to include all non-agency RMBS and CMBS, including private and foreign structured securities.

Not Rated (NR) symbol – The task force adopted an amendment effective December 31, 2019 to change the NR symbol to "not designated" (ND) given the legal meaning of "rating" under federal securities law.

Compilation instructions – The regulators adopted an amendment to the P&P Manual instructions for the SVO List of Investment Securities to confirm the policy that the SVO List of Investment Securities should not be used to determine whether securities are eligible for reinsurance collateral.

Fund investment framework – An amendment to provide a comprehensive framework for fund investments was re-exposed for comment. The proposal was also referred to the Blanks Working Group requesting an addition of a column to Schedule D, Part 2, Section 2 to allow insurers to report an NAIC Designation to funds designated by the SVO. Additionally, a referral was made to the Capital Adequacy Task Force requesting a review of all SVO designated funds to consider how such NAIC Designations would be included in the RBC calculation. Preliminary discussion at the CADTF did not appear to support expanding granularity in the common stock (D-2-2) schedule.

Filing exemption disclosure – The task force deferred adoption of the proposed P&P Manual amendment to improve the disclosure on securities not eligible for filing exemption until 2019 given the

ongoing debate on certain security types. For the eight classes of securities referred to in the proposal as not eligible for filing exempt, industry stated that they always interpreted three of these to be FE: credit tenant loans, SCA investments and regulatory transactions approved by domiciliary regulators. The chair agreed to the status quo for year-end 2018 so as to avoid any possible market disruptions. Industry committed to aggregate data on the size and scope of the privately rated CTL marketplace and summarize rating agency methodologies for CTLs.

Report on credit rating consistency
The SVO described a 2019 project being conducted with the North American Securities Valuation Association to develop electronic processes to map NAIC CRP credit rating symbols to the filing exemption designation and exclude those ratings that do not have the appropriate characteristics, in an effort to reduce reporting exceptions. The intent of the task force is to understand what credit ratings currently enter the automated process and "whether the ones that are being permitted to enter the computer process are, in fact, appropriate or consistent with the needs of the task force for FE." In discussing the complexity of the FE process, the SVO representative noted that the NAIC maintains a master translation table for all CRPs of their symbols, eligibility and the translated NAIC Designation; the master table is currently more than 2,500 symbols. The results of the mapping exercise will be posted to the NAIC website for comment.

Group capital calculation

In October, the working group heard comments from interested parties on the proposed approach to field testing, which were supportive of making the field testing open to all companies. During the Fall National Meeting, the working group presented the initial draft field testing template, which is designed to gather the necessary information to maximize the options for how to test and avoid limitations of the types of groups that can participate. The working group described each of the components of the template including 1) inputs, 2) calculations and 3) outputs.

The comment period for the template will run until January 30. Some of the initial questions raised during the National Meeting and clarified during the December 6 Webex demonstration of the template include the following:

- Use of the term "Required Capital"- the working group clarified that the use of the term was not meant to imply that the Group Capital Calculation will impose a group capital requirement. Consideration was given to changing the term to "Calculated Capital."

- XXX/AXXX captive carrying value - the instructions will be clarified to indicate that the base case carrying values should be unadjusted.

- Valuation adjustment for prescribed practices - the instructions will be updated to note that both permitted and state prescribed practices that differ from NAIC prescribed will be included in valuation adjustments.

- Subordinated debt of foreign participants - a new debt category will be added to capture contractually subordinated debt recognized by other jurisdictions.

The working group is particularly interested in feedback on the link between the instructions and the template, appropriateness and availability of the requested data, changes to the field testing options and time and duration of the testing. The working group anticipates finalizing the template in early spring and will use 2017 or 2018 data, depending on whether 2018 data is available. After analyzing the results of the first field testing exercise, including comparisons across options, the working group will refine the template for a second field test, which should include reduced testing options. Companies that are interested in participating should first discuss this with their domiciliary regulator.

Reinsurance Task Force

Credit for Reinsurance Model revisions
Since the Summer Fall National Meeting, the Reinsurance Task Force exposed its second and third drafts of proposed changes to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to reflect adoption of the new Bilateral Agreement between the U.S. and EU. Among other provisions, the agreement eliminates reinsurance collateral provisions on new reinsurance contracts for EU-based reinsurers meeting the conditions of the Bilateral Agreement. In addition to amending the models to be consistent with the Bilateral Agreement, revisions are intended to 1) provide reinsurers domiciled in NAIC-qualified jurisdictions other than the EU with similar collateral requirements, and 2) address the effects of a breach on collateral requirements and failure of a non-EU qualified jurisdiction to meet the standards imposed

by its agreement to comply with the bilateral agreement.

During the Fall National Meeting, the task force reviewed revisions made to June 21 draft, which include the following:

- Added guidance that credit for reinsurance may be taken only for reinsurance agreements entered into, renewed, or amended on or after the date the commissioner has determined that the assuming insurer is eligible.
- Added guidance that a qualified jurisdiction is required to "recognize the U.S. state regulatory system, including its approach to group supervision and group capital…including but not limited to confirmation by a competent regulatory authority."
- Removed a requirement to have a reconciliation of IFRS to U.S. GAAP in audited financial statements of non-U.S. domiciled reinsurers,
- Clarified that the models are not limiting alternative dispute resolution except to the extent such agreements are unenforceable under law, and
- Revised the models as a result of two comment letters received from the European Commission; certain changes were made to the models, while others were rejected after discussion with the Commission.

During its meeting in San Francisco, the task force heard final comments from interested parties. With respect to the concern that the models would create disparate treatment of U.S. domestic reinsurers, this issue was referred to the Reinsurance Financial Analysis Working Group for study. No substantive changes were made to the November 9 final draft of the models.

As the task force prepared for a vote, the chair stated its intent is not to create any disparate treatment of non-EU reinsurers or change oversight of non-U.S. group parents. With a roll call vote, the task force adopted the proposed revisions to Model #785 and #786.

At the Financial Condition Committee, the task force modified its recommendation which is to adopt the revisions as drafted, but with direction from the task force's drafting group to consider if any technical corrections or drafting notes are required based on the verbal comments raised in San Francisco, including additional review of the European Commission's November 16 comment letter.

A final version was expected to be considered by the Executive Committee and Plenary during its December 19 call. However, that action has been delayed due to input from the U.S. Treasury and U.S. Trade Representative received after the Fall National Meeting; the NAIC stated that they "need more time to properly consider that input before proceeding."

UK Covered Agreement

The U.S. Treasury Department and the United Kingdom have begun talks toward a separate covered agreement in anticipation of Brexit. The NAIC and state insurance regulators expect to participate in the process, which is anticipated to mirror the current EU agreement.

Qualified Jurisdiction Working Group

The working group reported it has begun work on its charge to revise its Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions as a result of the Covered Agreement; the working group expects a more expedited process for both reciprocal and qualified jurisdictions. The current list of qualified jurisdictions must be renewed by December 31, 2019; the working group will not begin any new evaluations until the revisions to the credit for reinsurance models are complete and the Qualified Jurisdiction Process has been updated.

Principles-based reserving

Valuation Manual amendments

Following the Summer National Meeting, activity of the Life Actuarial Task Force remained focused on VM Amendment Proposal Forms (APFs). APF 2018-08 was adopted in September, which removes the requirement for a company to meet a 450% RBC threshold to be exempt from PBR. Topics addressed in the APFs adopted in San Francisco include clarifying revisions, VM-31 reporting requirements, aggregation of mortality segments, and treatment of substandard extra mortality in the NPR calculation.

APF 2018-17 adopted in San Francisco clarifies the requirements for aggregation of mortality segments in determining credibility under VM-20. This APF had been discussed at length during several meetings throughout the year as the task force took time to fully consider the implications of the proposed amendment and subsequent revisions. The adopted provision allows aggregation of individual mortality segments if the mortality segments are subject to the

same or similar underwriting processes, and allows for either top-down or bottom-up aggregation, as long as the aggregate experience is actually reflected. The adopted provision delineates two approaches for underwriting processes to be considered “similar”: (1) based on published (or 3rd-party proprietary) studies and (2) based on retrospective analysis, and requires annual monitoring of experience mortality for segments resulting from sub-division of an aggregate class. Support for the determination that underwriting processes are similar, as well as the mortality experience analysis, require distinct documentation in the VM-31 Report.

APF 2018-57 exposed in San Francisco addresses Simplified Issue (SI) mortality through a general provision in VM-20 that for policies where the anticipated mortality experience materially exceeds the prescribed CSO mortality rates, companies shall adjust upward the CSO mortality rates used in the NPR calculation commensurate with the anticipated mortality experience for the policy. This APF was presented by the ACLI and is a response to challenges experienced in ongoing work by the Joint Academy/SOA Preferred Mortality Project Oversight Group to define, collect data and develop mortality tables for SI business. The APF is exposed for comment until January 3.

Reinsurance considerations

A topic of lengthy discussion at both Summer and Fall National Meetings was what, if any, future increases to nonguaranteed yearly renewable term reinsurance premiums should be reflected in the deterministic and stochastic reserves. VM guidance on this topic is limited and may result in inconsistent reserves between ceding and assuming parties and across companies having similar reinsurance arrangements. Two industry members presented an APF (2018-58) which proposes that ceding companies assume an increase in the YRT premium scale, if necessary, to achieve breakeven (i.e. present value of future reinsurance premium equals the present value of future reinsurance benefits) starting at the next date at which non-guaranteed premiums may be increased. The proposal also includes a provision that the reinsurance reserve credit cannot be negative. (The notion of a negative reserve credit was a topic of another discussion at this LATF meeting and is supported in currently exposed APF 2018-56 discussed below.) Comments from some industry members noted a preference for a principle-based approach that reflects each company’s own expectations for future experience, while regulator comments were generally supportive of the drafted proposal. LATF voted to expose the APF for comment until January 31.

LATF also heard from the Academy Reinsurance Work Group on the topic of reinsurance reserve credits. The work group presented an APF (2018-56) which, if adopted, would allow for a negative reinsurance reserve credit to the modeled reserve (i.e. the modeled post-reinsurance-ceded reserve is greater than the pre-reinsurance-ceded reserve). The work group asserts that such provision more accurately reflects the economics of the underlying reinsurance and therefore should be allowed, to ensure that reported gross reserves minus reported reserve credit always equals reported (post-reinsurance-ceded) minimum reserve. This proposed APF was exposed for comment until January 31.

The work group also presented a method for allocating the reinsurance ceded reserve credit, which is not explicitly addressed in VM-20.The presentation suggests that without more specific guidance, various interpretations may result in reporting anomalies and inconsistencies, including credit for reinsurance being allocated to policies without reinsurance and complications in the process of treaty-level allocation and reconciliation between annual statement schedules. The work group proposes allocation of the reinsurance ceded reserve credit on a basis that reflects the impact of each treaty to the insured policies; such bases may include the NPR credit, impact on modeled reserve, etc. No further action was taken at this meeting and discussion will continue on a future LATF call.

Experience reporting

LATF heard an update from the Experience Reporting Subgroup, including presentation of proposed changes to VM-51, Experience Reporting Formats, to add plan type sub-categories, which will support better analysis. The proposed approach would categorize policies by base plan type rather than specific product features within a plan type, and information regarding specific product features would be captured in distinct categories independent of base plan type. The subgroup expects that the proposed changes would require companies to implement systems changes to capture and report the information at the level of granularity proposed. LATF members voted to expose the proposal for public comment until January 31.

PBR report

At the meeting in San Francisco LATF discussed the Valuation Analysis Working Group’s 2017 Principle-Based Reserve (PBR) Review Report. The report presents findings from the working group’s review of the 2017 VM-20 Reserves Supplement and PBR Actuarial Reports and includes recommendations and referrals for VM amendments to clarify

requirements and improve company reporting of PBR reserves and supporting information to LATF.

The VAWG has requested that NAIC staff draft recommendations for changes to the Supplement design and instructions to clarify reporting requirements; these recommendations will be referred to LATF to consider sponsoring a proposal to the Blanks Working Group. The VAWG also recommended that LATF make a request for NAIC resources and the California Office of Principle-Based Reserving to jointly draft APFs prior to the 2019 Spring National Meeting.

VAWG members talked through the 36 recommended VM amendments from the Review Report, noting that some items will require regulator input. Regulator comments cited the need to strike a balance to provide content sufficient to convey the work performed, and not require additional "deep-diving" every year, and noting that discussions with companies ahead of time can be helpful in agreeing what detail is needed.

Regulators also discussed whether all items need to be addressed in the VM through APFs, or whether some could be addressed in an Academy Practice Note, noting the impracticality of requiring an APF every time the NAIC needs additional information in the PBR Report. One regulator asked whether an "Emerging PBR Issues" Work Group would be more expeditious than APFs or Academy Practice Notes, but the suggestion did not gain any traction. Discussion concluded with agreement that NAIC staff and the California Office of Principle-Based Reserving would review the report and refer recommendations to LATF during the spring timeframe, for potential inclusion in the VM for 2020.

VM-22 fixed annuity PBR

LATF heard updates from the VM-22 Subgroup, the Academy SVL Modernization Work Group and the Academy Annuity Reserves Work Group on activities related to fixed annuity PBR. The VM-22 Subgroup is targeting the necessary guidance to be incorporated into the VM to be in effect January 1, 2022, for valuations on the new basis effective December 31, 2022 at the earliest (transition rules may apply).

The Annuity Reserves Work Group updated LATF members on continuing development of the non-variable annuity PBR approach. Work group recommendations for VM-22 modeled reserve and exclusion testing methodologies are targeted for the end of 2019, anticipating LATF approval of concepts and VM-22 drafting to begin in 2020. The conceptual VM-22 approach centers on an exclusion test that determines whether the required reserve is a modeled reserve based on a VM-21-like framework, or a formulaic CARVM reserve based on current actuarial guidelines. The expectation is that higher risk product designs would follow a VM-21-like principles-based approach, which would exclude lower risk fixed annuities and SPIAs. The modeled reserve would be optional for some contracts and only required for contracts that fail to meet the exclusion test criteria. Where appropriate, VM-22 would be consistent with the principles found in VM-20 and VM-21.

The subgroup also communicated to LATF a need to clarify SPIA reserve methodology documentation (i.e. actuarial guidelines 9, 9A, 9B, and 9C) to remove references to terms that no longer have a corresponding reference in VM-22 to avoid confusion and any variations in interpretation. The subgroup will make such recommendations to LATF for consideration.

The SVL Modernization Work Group updated LATF members on its work to modernize the valuation rate setting process for all non-variable annuities, effectively phase two of the VM-22 work for immediate annuities. The work group is mindful that non-SPIA methodology updates may impact this group's final recommendations; however, the work group plan is to refresh all valuation rates regardless of the final VM-22 methodology. The approach currently under consideration reflects an initial single rate, locked-in at issue and updated quarterly. The valuation rates would equate projected interest on representative industry asset portfolios with interest on reserves under rising and falling interest rate scenarios. Rates would be adjusted for differentiating product features such as length of surrender charge period and benefit guarantees.

Variable annuities framework

The C-3 Phase II/AG 43 Subgroup held frequent calls September through November with the stated objective of translating the newly adopted variable annuity reserve and C-3 RBC framework to an updated version of AG 43, VM-21 and VM-01 (definitions of terms). The subgroup will implement the framework while addressing interested party feedback on the drafts of AG 43 and VM-21. Drafts of the partially completed VM-21 have been posted on the NAIC's website for comment. Key items representing either discussion points, draft mark-ups or industry feedback as of the December 12 call included the following topics.

Reserve "phase-in" calculation
The ACLI proposed consideration of a more simplified phase-in of reserve requirements under the new framework using the difference in reserves between the old framework and new framework on the effective date of VM-21. The proposal is as follows:

- The phase-in should be a straight-line amortization of the dollar difference in reserves required under the old and new frameworks as of 1/1/20.
- When determining the difference in reserves, the reserves for any reinsured business expected to be recaptured in 2020 is to be included in the reserve determination.

The subgroup is considering a guidance note to recommend that in the event of a divestiture or ceded reinsurance of business considered on 1/1/20, the regulator approving that transition should determine whether an adjustment is needed to the phase-in amount.

Non-prescribed scenario generators
The draft VM-21 allows for the use of non-prescribed scenario generators as long as the generators produce results that are consistent with the prescribed generator. In using non-prescribed scenario generators to determine the return for proxy funds that cannot be mapped to the prescribed generator, the scenarios so generated must be consistent with the general relationships between risk and return observed in those of the fund returns from the prescribed scenario generator.

The draft VM-21 states that for a company not using the "safe harbor" approach, any implied volatility scenarios generated using a non-prescribed scenario generator shall not result in a Total Asset Requirement that is less than that which would be obtained by assuming that the implied volatility level (at all in-the moneyness levels and at a given time step in a given scenario) is equal to the realized volatility of the underlying asset scenario over the same time period.

Industry representatives expressed the desire to keep the original AG 43 wealth-ratio calibration guidelines in the final draft. While no longer required, the guidelines are useful for assessing the stratification of scenarios from the full set, which is a common industry practice. The subgroup expressed a willingness to include the wealth ratios in an appendix of the final draft.

"Guardrails" for general account asset modeling
The draft states that any model investment strategy and any non-prescribed asset spreads shall be adjusted as necessary so that the aggregate reserve is not less than that which would be obtained by substituting an alternative investment strategy in which all fixed income reinvestment assets are public non-callable corporate bonds with gross asset spreads, asset default costs, and investment expenses by projection year that are consistent with a credit quality blend of 50% VM-20 principles-based reserve ("PBR") rating 6 (A2/A) and 50% VM-20 PBR rating 3 (Aa2/AA). This provision will be referred to LATF for further discussions.

Experience study on sponsored plans business
Oliver Wyman (OW) proposed that they perform an experience study of policyholder behavior on employer-sponsored plans in order to evaluate the need for refinements to the Standard Scenario prescribed policyholder behavior assumptions. Employer-sponsored plans are comprised primarily of 403(b) plans but also include 457 plans and 401(k) plans. OW noted that their original study excluded employer-sponsored plan business, which is expected to exhibit unique policyholder behavior due to key product design differences such as ongoing automatic premium contributions. OW noted that there is already buy-in from several major writers in the space. The subgroup supports the proposal. OW expects to present results in early 2019, at which point the need for assumption refinements will be evaluated.

CDHS risk offset exclusion
The subgroup considered and agreed on alternate language in VM-01 that would exclude from the definition of Clearly Defined Hedging Strategy any strategy that seeks to offset the risks of products subject to VM-21 with risks of other products subject to different valuation manuals.

Alternative methodology for reserves and capital
The subgroup proposed retaining the alternative method as currently written for reserve calculations, along with the removal of a standard projection floor and the substitution of the AG 33 floor for the current standard projection floor. The subgroup also proposed to retain the current RBC alternative calculation method but with an update for tax reforms.

Interaction between SSAP 108 and VM-21
At least one regulator is of the view that hedges subject to the newly-adopted SSAP 108 are to be excluded from the proposed treatment of existing hedges in the VM-21 stochastic CTE amount calculation, i.e. hedges that are assumed to be liquidated at time zero in the "adjusted" CTE run will exclude those that are subject to SSAP 108. The subgroup has not agreed to any changes to VM-21 as a result of this discussion, but further debate could occur.

Valuation Manual exposures
The subgroup voted to expose the draft of sections 8 (scenario generation) of VM-21 and VM-01 for comments by January 22 and re-expose updated VM-21 sections 1-5. The subgroup plans to expose complete drafts of VM-21 at least twice once all sections are drafted, and will continue to meet frequently in 2019.

Retirement security initiative

As part of its charge on retirement security and the possibility of developing "unbiased" educational materials, the Life Insurance and Annuity Committee heard a presentation from the NAIC's Center of Insurance Policy and Research on its study, Quest for Retirement Security in a Changing World. The purpose of the study is to provide an understanding of the challenges faced by current and future retirees and insurers. The CIPR representative discussed creating a series of 10 papers to be compiled into one unified study to initiate debate and solutions; it would include discussion of evolution of the retirement system, the changing landscape, challenges in planning, and emerging trends and innovation.

Life Actuarial Task Force

GRET
During the fall the task force adopted the 2019 Generally Recognized Expense Tables.

Individual annuity nonforfeiture
At the Fall National Meeting LATF members heard an update from the Model #805 (Standard Nonforfeiture Law for Individual Deferred Annuities) Drafting Group on its work to address determination of individual annuity nonforfeiture values in compliance with the Model #805 prospective test. A draft actuarial guideline exposed at the Spring National Meeting addresses treatment of common annuity features and testing required to certify compliance with the law, emphasizing gradual convergence of cash surrender benefits to the paid-up annuity benefit available at maturity, deemed to be the later of age 70 or the tenth policy anniversary (the "70/10" test).

Comments on the draft guideline were, as noted by the drafting regulator, "uniformly negative" and suggest that industry does not perceive a need for uniform interpretation similar to standards adopted by the IIPRC (Compact). As such, the drafting group will abandon this project. The drafting group also discussed downgrading the Annuity Nonforfeiture Model Regulation (#806) to model guidance due to limited adoption of the model regulation by states. No further action was taken at this meeting.

Long-term care issues

LTC actuarial topics
The LTC Actuarial Working Group heard a status update of the LTC Valuation Work Group, which is developing recommendations for mortality and lapse for use in the calculation of statutory reserves at the request of the LTC Actuarial Working Group. Included in the presentation were graphs comparing the ultimate LTC basic mortality (without valuation PAD) to the 2012 IAM Basic Table. Regulators asked questions regarding the development of the LTC mortality. A draft report is expected in the second quarter of 2019.

An AAA representative noted the release of the Academy's issue brief Long-Term Care Insurance: Considerations for Treatment of Past Losses in Rate Increase Requests, published in October 2018. Causes for past losses cited are past persistency in excess of expected, past claims in excess of expected claims, state rate approval delays or limitations, and insurer delays in the filing process. Other considerations addressed in the issue brief are pricing differences from industry standards, past and future investment returns, and the treatment of past premium shortfalls. The issue brief concludes that the current LTC Model Regulation avoids the recoupment of past claim losses. Further restricting premium rate increases such that future claims are not funded could have severe financial implications and does not follow the 2014 NAIC LTC Model Regulation.

The working group also heard a presentation on work by the SOA and LTCG on morbidity improvement. Together, SOA and LTCG are studying the last SOA LTC Experience Study data to identify and measure the existence of any morbidity improvement in the submitted data, which thus far

is inconclusive. The final report was issued December 18.

The LTC Pricing Subgroup finalized a document which illustrates two methods for the review of LTC rate increase filings: the Blended Make-Up (also referred to as "if knew") used by MN, and the Prospective Present Value used by TX. Topics to be addressed by the subgroup in 2019 include gathering and sharing information via a state survey on methods and limitations used by states to review LTC rate increase filings. The chair noted the possible need for special considerations for LTC rate increase filings in which solvency was an issue, or group coverage where there is little or no underwriting and possibly some employer pay.

The LTC Valuation Subgroup noted that guidance has been developed for AG 51, The Application of Asset Adequacy Testing to Long-Term Care Insurance Reserves; new requirements include inforce metrics, additional detail discussion of the morbidity assumptions used, sample calculations using specified mortality and interest, information on new or changes to reinsurance, and four prescribed sensitivities. The guidance is available on the NAIC's website, AG 51 Guidance Document Year-end 2018.

Financial Stability Task Force

Liquidity disclosures
The task force heard an update on the status of new liquidity disclosures to be implemented in the 2019 life and fraternal annual statement; the Blanks Working Group adopted the final instructions in San Francisco and a new summary page to help tie individual pages to Summary of Operations page. At that meeting, the working group heard comments from professional reinsurers which have significant concerns that they will not have access to the necessary data to complete the revised Analysis of Operations and Analysis of Reserves schedules. (Implementation of the changes is expected to require significant effort by most, if not all, life insurers.) FSTF staff will be meeting with those reinsurers to develop possible solutions. Staff noted that a revised data call template has been posted to the NAIC's website, which could be revised again as a result of the professional reinsurers' issue. The data call will be due to the NAIC May 1, 2019 based on year-end 2018 data.

Liquidity stress testing framework
The Liquidity Assessment Subgroup exposed for comment this summer its Scope Considerations and Design Elements Considerations for a Liquidity Stress Test. The documents suggest the following life insurer activities and thresholds that might trigger the requirement to perform stress testing: issuance of fixed and indexed annuities ($25 billion of reserves), funding agreements and GICs ($10 billion of reserves), derivatives ($1 billion of fair value totals from Schedule DB), securities lending ($2 billion in fair value reported on Schedule DL), repurchase agreements ($1 billion) and borrowed money ($1 billion in carrying value).

After hearing comments from interested parties, the subgroup revised the threshold for derivatives to $75 billion in notional value. The change in criteria increased the number of large life insurers meeting one or more of the thresholds from 21 to 23 companies. At the meeting of the Financial Stability Task Force, the scope document was re-exposed for comment until December 17.

Other tentative conclusions reached by the subgroup include: liquidity stress testing should be performed annually, individual company results would be confidential, but aggregate results and implications for the broader financial markets might be disclosed publically. It is not anticipated that liquidity stress testing results would trigger any automatic or mandatory regulatory actions.

FSOC representative
Superintendent Eric Cioppa of Maine was confirmed in September by Plenary as the NAIC's representative on the Financial Stability of Oversight Council for the next two year term.

Holistic framework
The International Association of Insurance Supervisors has released for consultation a paper entitled, Holistic Framework for Systemic Risk in the Insurance Sector, with comments due January 25; the task force will be providing comments to the International Insurance Relations Committee for its consideration. The chair noted that the consultation paper is built on the premise that systemic risk can arise "both as a result of distress or disorderly failure of an individual firm and as a result of the collective actions of firms that have common risk exposures." The holistic framework includes an enhanced set of policy measures designed to pre-empt the sector vulnerabilities from becoming systemic issues, and a sector-wide data collection and global-monitoring exercise intended to detect the build-up of systemic risk.

The chair reported that the Financial Stability Board issued a press release on these enhancements, and in light of the IAIS' progress in developing the holistic

framework, the FSB has decided not to propose any G-SIIs in 2018. Once the holistic framework is finalized in November 2019, with application in 2020, the FSB will assess the IAIS recommendation to further suspend the G-SII identification process.

International Insurance Relations Committee

ComFrame and ICS 2.0
The committee approved submission of NAIC comments on the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) and the Insurance Capital Standard (ICS) version 2.0. On ComFrame, for this consultation, the focus of comments was on key issues. With respect to ICS 2.0, the committee provided narrative responses to many of the 198 questions. NAIC key issues include continuing concerns related to capital resources, market-adjusted valuation and margin over current estimates, as well as newer issues such as spread over the long-term forward rate, non-default spread risk and internal models.

ICPs 6 and 20
The committee approved the submission of NAIC comments on revised IAIS Insurance Core Principle (ICP) 6 - Change of Control and ICP 20 - Public Disclosure and a draft Issues Paper on the Increasing Use of Digital Technology in Insurance and its Potential Impact on Consumer Outcomes. The task force comments focused on ensuring the standards and guidance allow for sufficient jurisdictional flexibility and are not overly prescriptive. The revised ICP 6 has subsequently been adopted by IAIS.

Other IAIS papers
The task force approved submission of NAIC comments on the following three documents 1) the IAIS draft Application Paper on the Composition and the Role of the Board, 2) the IAIS draft Application Paper on Supervision of Insurer Cybersecurity and 3) the Financial Stability Board's draft Cyber Lexicon. The comments on the application papers are mostly editorial in nature. All of the comment letters are posted to the committee's web page (under Related Documents).

During the Fall National Meeting, an update was given on some of the recent IAIS developments; several issue papers have been adopted including the Increasing Digitalisation in Insurance and its Potential Impact on Consumer Outcomes. There were also developments on a number of application papers including the adoption of the Application Paper on the Use of Digital Technology in Inclusive Insurance. Additionally, two new application papers, Supervision of Insurer Cybersecurity and the Composition and the Role of the Board, were released for comment.

Risk-focused surveillance

Examiners Handbook guidance
Guidance for the Financial Condition Examiners Handbook proposed by the Efficiency Drafting Group of the Risk-focused Surveillance Working Group was adopted this fall. The guidance includes a new Exhibit D, Planning Meeting with Financial Analyst, and other revisions to reduce redundancies in the solvency monitoring process.

Peer review sessions
NAIC staff hosted four different peer review sessions related to insurance department examinations in 2018 which were attended by sixteen different states. The sessions were intended to identify emerging best practices, as well as common challenges in examinations. Much of the feedback was addressed through the development of clarifying guidance for the Financial Analysis Handbook. Four more sessions are being planned for 2019, two of which will focus on implementation of the risk-focused analysis approach, and a tentative plan for a session on integration of ORSA into the exam and analysis process.

P/C Appointed Actuary attestation

The Casualty Actuarial and Statistical Task Force has been developing an actuarial attestation form that would be completed and signed annually to verify that the actuary is qualified to sign a statutory P&C Statement of Actuarial Opinion. Since the Summer National Meeting, the task force exposed a revised proposal.

Feedback from the AAA noted that there is no specified format of the attestation; they also requested specific detail on the experience of the actuary be provided, given the risk of an actuary performing work outside of his/her area of expertise. The task force indicated that they would not incorporate proposed changes from the comment letters prior to handing the proposal off to the Executive Committee's ad hoc commissioner group for consideration in the 2019 Statement of Actuarial Opinion Instructions. On December 15, the Executive Committee exposed the 2019 revised Instructions incorporating the task force's proposed

edits, with comments due by February 15. Following the comment period, there will be a 90-minute public hearing held on March 22.

The exposure includes the following proposed revised guidance:

> The Board of Directors shall document annually the company's review that the actuary meets the requirements to be an Appointed Actuary. The actuary shall provide qualification documentation to company management annually and include such documentation in the subsequent Actuarial Report. All items in the definition of Qualified Actuary shall be addressed in the qualification documentation. The qualification documentation should include specific actuarial experiences relevant to the company's structure and lines of business. The qualification documentation shall be available for inspection upon regulator request or during a financial examination.

Significant proposed revisions to the definition of Qualified Actuary include the following:

> A Qualified Actuary is a person who has sufficient experience and knowledge obtained through basic education, continuing education, or experience to understand reserving for the company's lines of business and business activities, and is a member of a professional actuarial association subject to the same Code of Professional Conduct promulgated by the Academy, the U.S. Qualification Standards, and the Actuarial Board for Counseling and Discipline when practicing in the U.S.

As part of these changes to the instructions to the Statement of Actuarial Opinion, in a separate work stream, the NAIC (through the Actuarial Opinion Working Group) is working to define what the minimum basic education, and also potentially the continuing education and experience requirements are for an Appointed Actuary. In addition, the NAIC will define what the accepted credentials for an Appointed Actuary are. Based on the timeline for this Educational Standards and Assessment Project, the NAIC hopes to have the new standards effective for year-end 2019 actuarial opinions. This project may likely impact the syllabus of the SOA and the CAS, as well as the AAA's qualifications standards.

Climate change developments

The Climate Change Working Group held a panel discussion in San Francisco on innovative resilience financing solutions that make the reduction of insurance risk financeable with investor capital. Innovative solutions include a forest resilience bond to address the overgrowth of forests and rising cost of fire suppression, an environmental impact bond to reduce storm water overflow and implementation of more green drainage solutions, and a coastal zone management trust that will finance a parametric insurance policy to preserve mangroves and coral reefs that protect the coast from hurricanes. The working group also heard an update on recent climate change related summits and conferences.

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The next National Meeting of the NAIC will be held in Orlando April 6-9.

We welcome your comments regarding issues raised in this newsletter. Please provide your comments or email address changes to your PwC LLP engagement team, or directly to the NAIC Meeting Notes editor at jean.connolly@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 meeting materials to industry observers at the meetings, it can be 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.

Appendix A

This table summarizes actions taken by the SAP Working Group since the PwC NAIC 2018 Summer National Meeting Newsletter on all open agenda items. Items exposed for comment are due February 15, 2019. For full proposals exposed and other documents see the SAP Working Group webpage.

Issue/ Reference #	Status	Action Taken/Discussion	Proposed Effective Date
SSAP 22 - ASU 2016-02 - Leases (#2016-02)	NAIC staff is working with industry	A substantively revised SSAP 22R was re-exposed for comment at Summer National Meeting, along with the proposed issue paper, which retains the guidance that all leases are operating leases. NAIC staff is working directly with industry on their comments with another issue paper anticipated at the 2019 Spring National Meeting. Industry has asked for clarification of the proposed sale/leaseback guidance including confirmation that EDP equipment and software may be sold and leased back and whether any GAAP sale/leaseback guidance related to real estate is applicable for statutory accounting.	Years ending December 31, 2019 with early adoption permitted
SSAP 108 - Derivatives Hedging Variable Annuity Guarantees (#2016-03)	Adopted	The regulators adopted a new SSAP 108 on hedging variable annuities. See additional discussion in the SAPWG summary above.	January 1, 2020, with early adoption permitted January 1, 2019
ASU 2016-13 - Credit Losses (#2016-20)	Staff reviewing comment letter	NAIC staff is continuing discussions with industry representatives; see additional discussion in the SAPWG summary above.	TBD
SSAP 41 – Surplus Note Amortization and Accretion (#2017-12)	Discussion deferred	NAIC staff continues to work with industry to resolve issues and propose related accounting for surplus notes issued at a discount. There was no discussion of this issue at the Fall National Meeting.	TBD
SSAP 61R and SSAP 62R – Reinsurance Risk Transfer for Short Duration Contracts (#2017-28)	Adopted (SSAP 62R) and Referred (SSAP 61R)	The working group continued discussion of proposed revisions to SSAP 61R and adopted proposed changes to SSAP 62R. See additional discussion in the SAPWG summary.	January 1, 2019 for the SSAP 62R revisions
SSAP 30 – Investment Classification Project (#2017-32)	Adopted	The working group adopted exposed revisions to SSAP 30R to clarify the definition of common stock and to include closed-ended funds and unit investment trusts in that definition. The regulators also adopted the related Issue Paper.	January 1, 2019
SSAP 86 – ASU 2017-12, Derivatives and Hedging (#2017-33)	Discussion deferred	This project will continue to review the overall accounting and reporting changes required by this ASU as potential substantive revisions to SSAP 86. The simplified hedging documentation standards were bifurcated into a separate project (#2018-30) as discussed below.	TBD
SSAPs 21 & 26 – Bank Loan Referral (#2018-04)	Staff research continuing	Earlier this year, the working group exposed for comment a proposed recommendation that "borrowing base loans" and "DIP financing loans" be classified as collateral loans as opposed to bank loans under SSAP 26R. NAIC staff has been researching bank loans and discussing with industry the types of bank loans insurers invest in, with a revised exposure draft expected shortly.	TBD

Appendix A

Regulatory Transactions Referral from the Reinsurance Task Force (#2018-06)	Staff is reviewing comment letter	At the Summer National Meeting, the working group re-exposed for comment proposed new wording for SSAP 4 to address invested assets acquired in connection with "regulatory transactions." In its November 30 comment letter, industry reiterated its concerns related to the overly broad scope of the proposal and asked for information on the specific types of transactions the working group is trying to address. Discussion will continue in early 2019.	TBD
SSAP 41R – Surplus Notes Linked to Other Structures (#2018-07)	Staff is reviewing comment letter	At the Summer National Meeting, the SAP Working Group re-exposed for comment proposed revisions to SSAP 41R to disallow capital treatment for surplus notes which are linked to other structures that are not subordinate. See further discussion in the SAPWG meeting summary above.	TBD
SSAPs 21 & 56 – Private Placement Variable Annuities (#2018-08)	Adopted	As a follow up to the adoption of new accounting and disclosure guidance for COLI assets, the working group provided sample wording for the new required disclosure of the "primary underlying investment characteristics" of invested cash surrender value. Insurers are asked to disclose information by investment category, e.g. percentage of total invested in bonds, stocks, mortgage loans, real estate, derivatives, etc.	December 31, 2018 for the new disclosure
SSAP 21 – Structured Settlements (#2018-17)	Adopted	The working group adopted proposed accounting for structured settlements acquired in accordance with applicable state and federal law; these investments will be reported on Schedule BA and will be initially recorded at cost.	December 31, 2018
SSAPs 2, 26R, 43R & 86 – Structured Notes (#2018-18)	Re-exposed	The working group re-exposed proposed revisions to provide guidance on securities with non-credit related risk as to principal. See additional discussion in the SAPWG section above.	TBD
SSAP 43R – Elimination of the MFE Process (#2018-19)	Adopted	The regulators adopted revisions to SSAP 43R to eliminate the modified filing exempt process for non-modeled SSAP 43R securities. See the summary of the VOSTF for additional discussion.	March 31, 2019 with early adopted permitted
SSAPs 15 & 25 – Forgiveness of Related Party Debt (#2018-20)	Adopted	The working group adopted minor revisions to these SSAPs, providing additional guidance regarding when related party debt forgiveness is deemed to be a capital contribution.	November 15, 2018
SSAP 72 – Return of Capital (#2018-21)	Adopted	Clarifying guidance was adopted for SSAP 72 for determining whether a distribution is a dividend versus a return of capital. In general, dividends should be recorded when the investee has undistributed earnings.	November 15, 2018
SSAP 37 – Acquired Mortgage Loans (#2018-22)	Re-exposed	Proposed revisions to SSAP 37 were re-exposed to clarify guidance for mortgage loan participation agreements. See additional SAPWG discussion above.	TBD
SSAP 68 – Statutory Mergers (#2018-23)	Adopted	The working group adopted revisions to SSAP 68 to clarify that combinations of entities that include insurance companies in which no new equity is issued should be accounting for as a statutory merger with the prior periods restated. This would include parent and subsidiary mergers.	November 15, 2018

Appendix A

SSAP 25R – ASU 2018-01 (#2018-25)	Adopted	The regulators rejected ASU 2018-01, Leases-Land Easement Practical Expedient for Transition to Topic 842.	November 15, 2018
SSAP 97 – Negative equity of SCAs (#2018-26)	Re-exposed	In connection with the new SCA loss tracking disclosures, the working group is studying in which circumstances an SCA should be reported at negative equity when the insurance company parent has guaranteed obligations of the SCA or provided commitments. NAIC staff will be working with industry to review GAAP guidance in this area to determine whether revisions to paragraph 13.e are necessary.	TBD
SSAPs 48 – Loss Tracking Disclosures (#2018-27)	Adopted	The working group adopted a loss tracking disclosure for SSAP 48 entities, similar to that required for SSAP 97 entities (#2018-09).	December 31, 2018
SSAPs 51, 52, and 61R – Liquidity Disclosures (#2018-28)	Adopted	The working group adopted revisions to Note 32 and added Note 33 related to life insurance and variable annuity liquidity risks.	December 31, 2019
Appendix A-820 – Consistency with Standard Valuation Law (#2018-29)	Adopted	To correct an inconsistency between the Minimum Life and Annuity Reserve Standard included in the APP Manual and the Standard Valuation Law, the working group adopted deletion of the phrase "good and sufficient reserve" from Appendix A-820.	November 15, 2018
SSAP 86 – Hedge Effectiveness Documentation (#2018-30)	Adopted	The working group adopted limited provisions from ASU 2017-12, Derivatives and Hedging, to simplify hedge effectiveness documentation requirements. See the SAPWG summary above for additional detail.	January 1, 2019 with early adoption permitted for year-end 2018
SSAP 6 – Extension of the 90 Day Rule (#2018-31)	Adopted	The working group adopted a voluntary 60-day extension of the 90 day rule under SSAP 6 for uncollected premiums from policyholders affected by hurricanes Florence and Michael.	November 15, 2018, expiring March 9, 2019
SSAP 26R – Prepayment Penalties (#2018-32)	Exposed	To address questions received by staff, the working group exposed for comment proposed revisions to SSAP 26R on determining the prepayment penalty for called bonds when the consideration received is less than par and whether additional illustrations for called bonds are needed.	TBD
SSAP 30R – Pledges to FHLBs (#2018-33)	Exposed	The working group exposed for comment a clarification that pledges of assets to a Federal Home Loan Bank by an insurer on behalf of an affiliate should be non-admitted. The working group also asked for comments on other FHLB-related activities an insurer might engage in for an affiliate.	TBD
SSAP 30R – Foreign Mutual Funds (#2018-34)	Exposed	Because the revised definition of common stock mutual funds (#2017-32) only includes SEC registered funds, industry has asked for guidance on foreign mutual funds. The exposure would revise SSAP 30R to explicitly allow foreign open-end mutual funds. The working group is also asking for specific feedback on other issues including whether only certain jurisdictions' mutual funds should be included and RBC-related questions.	TBD

Appendix A

SSAP 104R and SSAP 95 – ASU 2018-07, Improvements to Nonemployee Shared-Based Payments (#2018-35)	Exposed	Proposed revisions to SSAP 104R were exposed for comment to align the statutory guidance with the new GAAP guidance that applies the same requirements to both employee and non-employee share-based payments, which were previously significantly different. The proposal would eliminate the current SSAP 104R separate section on non-employee share-based payment guidance and apply the employee guidance to both.	TBD
SSAP 100R – ASU 2018-13, Changes to the Disclosure Requirements of Fair Value Accting (#2018-36)	Exposed	The working group is proposing adoption of the majority of ASU 2018-13, which removes certain fair value disclosures and modifies others. In addition, two new GAAP disclosures are proposed not to be adopted for statutory related to level 3 assets.	TBD
SSAP 92 and 102 – ASU 2018-14, Changes to the Disclosure Requirements of Defined Benefit Plans (#2018-37)	Exposed	The working project is proposing adoption of nearly all of ASU 2018-14, which removes some current disclosures, clarifies others and adds two new disclosures related to interest crediting rates and reasons for significant gains and losses related to changes in the benefit obligation. Changes not adopted related to removal of disclosures for non-public entities; the NAIC requires the same disclosures for public and non-public entities.	TBD
SSAP 55 – Prepaid Providers (#2018-38)	Exposed	The regulators are proposing clarification to SSAP 55 that prepayments to providers of claims and adjusting services should be recognized as miscellaneous underwriting expenses, with reclassification to claims expense or claims adjusting expense, as applicable, as the claims are paid. The example used in the exposure is prepaid roadside assistance to a separate provider.	TBD
SSAP 55 – Interest on Claims (#2018-39)	Exposed	This exposure would require that interest paid on A&H claims in accordance with prompt pay or other similar regulations would be classified as other claim adjustment expenses. The working group asked for comments on whether the guidance should apply to other lines of business and an appropriate effective date.	TBD
SSAP 16R/22 ASU 2018-15, Cloud Computing (#2018-40)	Exposed	The working group directed staff to draft revisions to adopt this ASU with modifications. See the SAPWG summary above for additional discussion.	TBD
SSAP 86 – Benchmark Interest Rates (#2018-46)	Exposed	As a result of the issuance of guidance by the FASB, the working group exposed revisions to add the Securities Industry and Financial Markets Municipal Swap Rate and the Secured Overnight Financing Rate Overnight Index Swap Rate as U.S. benchmark interest rates for hedge accounting.	TBD
Issue Paper 99 – Proposals to reject recent GAAP guidance	Exposed	The working group exposed for comment proposed rejection of the following GAAP guidance as not applicable to statutory accounting: ASU 2017-13, Amendments to SEC Paragraphs (#2018-41), ASU 2018-02, Reclassification of Certain Tax Effects from AOCI (#2018-42), ASU 2018-04, Debt Securities and Regulated Operations (#2018-43), ASU 2018-05, Income Taxes, Amendments to SEC paragraphs (#2018-44), and ASU 2018-06, Codification Improvements to Topic 942 (#2018-45).	2019 Spring National Meeting

Appendix B

This chart summarizes action on other proposals of the RBC Working Groups since the 2018 Summer National Meeting, i.e. those not discussed on pages 5-6 of this Newsletter. The detail of all proposals adopted for 2018 RBC are posted to the Capital Adequacy Task Force's webpage (under Related Documents).

RBC Formula	Action taken/discussion	Effective Date/ Proposed Effective Date
All formulas		
Stop Loss Interrogatories (2018-14-CA)	The Capital Adequacy Task Force **exposed** for comment a proposal to capture additional health stop loss data to allow regulators to distinguish between aggregate and specific stop loss data.	2019 RBC Filings
Rounding Function in Capitation Tables (2018-17-CA)	The Health RBC Working Group **referred** this recommended change to the Capital Adequacy Task Force for exposure, which would add a rounding function to the Health formula, making it consistent with the Life and P/C formulas. In addition, the proposal would make the tables captured electronic-only for all three formulas.	2019 RBC Filings
P/C RBC		
Catastrophe List Event (2018-15-CR)	The Capital Adequacy Task Force **adopted** the catastrophe event list for 2018 RBC filings.	2018 RBC Filings

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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, **Joanne Smith**, via **sofe@sofe.org**

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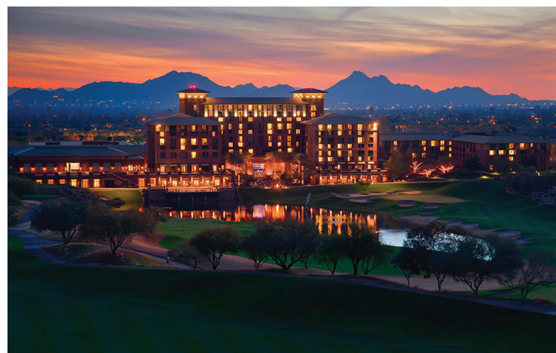

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