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Willkie Insurance Industry Review

Corporate and Risk Transactions,
Regulation and Tax Developments

January 2020

Willkie Insurance Industry Review

January 21, 2020

To Our Clients and Friends:

We are pleased to present the Willkie Insurance Industry Review of recent important developments in corporate transactions, insurance risk transfers, regulation and tax in the insurance sector. This includes a discussion of mergers and acquisitions, corporate governance and shareholder activism, insurance-linked securities, excess reserve financings, longevity and derisking transactions, traditional capital markets transactions and the regulation and taxation of insurance companies, covering the United States, the E.U., as well as the U.K.'s company and Lloyd's markets.

We hope that you find this Willkie Insurance Industry Review informative. Please contact us if you would like further information about any of the topics covered in this report.

Sincerely,

Insurance Transactional and Regulatory Practice

Willkie Farr & Gallagher LLP

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I. REVIEW OF M&A ACTIVITY

A. U.S. and Bermuda

While the overall level of insurance industry M&A activity remained strong in 2019, the aggregate value of announced deals declined compared to 2018. The principal reason for this decline was the relative absence last year of “blockbuster” transactions. Deal value in 2018 was fueled in large part by acquisitions of Bermuda-based insurers/reinsurers. These included AXA’s acquisition of XL Group (\$15.39 billion), American International Group’s acquisition of Validus Holdings (\$5.6 billion), the acquisition of Aspen Insurance Holdings by funds managed by Apollo (\$2.6 billion) and RenaissanceRe Holding’s acquisition of Tokio Millennium (\$1.5 billion). In contrast, no Bermuda deal with a value exceeding \$1.0 billion was announced in 2019 and the largest U.S. deal announced in 2019 (New York Life Insurance Company’s acquisition of Cigna’s group life and disability businesses) was less than half the size of the AXA/XL Group transaction. In an industry where blockbuster transactions are rare, the occurrence of one or two such transactions in a year can significantly skew comparisons with prior periods based on deal value. Also, much of the deal activity in 2019—particularly in the life and health sector—involved the sale of blocks of business effected through reinsurance. These transactions are not always counted by public M&A databases, making it difficult to compile complete lists of deal activity and complicating comparisons with prior periods.

i. Life and Annuity Transactions

In 2019 no “blockbuster” transactions occurred in the life and annuity sector. In fact, only three legal entity transactions that exceeded \$1.0 billion in deal value were announced last year: Cigna’s sale of its group life and disability businesses to New York Life Insurance Company (\$6.3 billion); an investor group’s acquisition (led by The Carlyle Group) of substantially all of AIG’s interest in Fortitude Re (\$1.795 billion); and Resolution Life Group Holdings’ acquisition of Voya Financial’s individual life

insurance and legacy annuity businesses (\$1.25 billion). The Cigna transaction makes it clear that the group business continues to be an attractive segment of the life insurance market with substantial interest on the part of acquirers. This acquisition, the most significant one by New York Life in many years, will significantly increase that mutual’s presence in this segment and will permit Cigna to focus on its core healthcare businesses.

AIG established Fortitude Reinsurance Company (formerly known as DSA Re) in Bermuda to reinsure nearly \$40 billion of AIG’s legacy life and annuity and general insurance liabilities. In 2018, Carlyle acquired a 19.9% stake in the company, and AIG and Carlyle formed Fortitude Group Holdings, which operates as Fortitude Re, to become an aggregator and manager of runoff blocks. In the deal announced in November 2019, a newly created Carlyle-managed fund, together with Japan’s T&D Holdings, the publicly listed holding company for Taiyo Life Insurance Company and Daido Life Insurance Company, partnered to acquire from AIG an additional 76.6% ownership interest in Fortitude Re for approximately \$1.8 billion. After closing, ownership interests in Fortitude Re will include Carlyle and its fund investors at 71.5% (including the 19.9% stake previously acquired by Carlyle in 2018), T&D at 25% and AIG at 3.5%. In connection with the transaction Carlyle will continue its strategic asset management relationship with Fortitude Re. As is the case with many life insurance deals involving financial sponsors, creating or maintaining an asset management relationship with the acquired company which leverages the financial sponsor’s asset management capabilities is an important driver of financial sponsor interest in this sector.

In December, Sir Clive Cowdery’s newly formed Resolution Life Group Holdings agreed to acquire substantially all of Voya’s individual life and other legacy non-retirement annuities businesses for \$1.25 billion. In its press release announcing the deal, Voya stated that the transaction is expected to accelerate the allocation of approximately \$1.7 billion in deployable capital from individual life and will reduce exposure to interest rate, credit and mortality risk. Earlier in 2019 Resolution announced its revised agreement to acquire Australian financial institution AMP Limited’s

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Australian and New Zealand Mature and Wealth Protection businesses. Also, in 2019 Sir Clive's prior fund agreed to sell Lincoln Benefit Life Company to affiliates of Kuvare Holdings after an earlier agreement to sell the company to troubled consolidator Global Bankers was terminated.

Notwithstanding the absence of a significant number of large legal entity transactions in the life and annuity space, the market for blocks of business remained active in 2019, and should remain so in 2020 and beyond. For example, Protective Life, a subsidiary of Japan's The Dai-Ichi Life Insurance Company, acquired Great-West's individual life and retirement business in a reinsurance transaction valued at approximately \$1.2 billion.

Increasingly, these types of transactions are at the core of M&A activity in the life sector. Various factors are responsible for this development. Among them is the pressure on insurers from rating agencies, equity analysts and investors to optimize their liability portfolios and exit businesses that are capital intensive, non-core, volatile or otherwise problematic (e.g., long-term care). In addition, the scale bar is rising constantly, causing companies to evaluate these operations regularly. A long-term, low interest rate environment has also been a significant factor encouraging exits from certain lines of capital-intensive and relatively low-return businesses.

A growing roster of buyers is competing for blocks of life insurance and annuity business including industry consolidators such as Protective, RGA and Wilton Re; platforms affiliated with private equity firms such as Apollo, Blackstone and Carlyle; and some of the larger mutual insurers. These buyers typically bring significant expertise and experience with respect to runoff management. As a result, deals that in prior years might have been difficult to accomplish, such as acquisitions of blocks of long-term care and variable annuities business, are getting done. We also note that legislative developments in certain states may further facilitate the acquisition of blocks of business. As we discuss more fully below, several states have adopted business transfer legislation that permits the "division" of an insurer into separate legal entities in a sort of corporate mitosis. The practical and legal benefits of these statutes

to the sponsoring insurer are manifest—but one significant benefit will be to permit a block reinsurance transaction to be structured as a sale of a legal entity which will substantially reduce counterparty credit exposure and the potential application of counterparty risk capital charges, which is a recurring issue in large block reinsurance trades.

ii. Property/Casualty Transactions

Unlike the prior year, P&C M&A transactions did not fuel deal volume in 2019. After several years of consolidation the number of Bermuda-domiciled acquisition candidates has decreased significantly. In addition, while valuations of specialty insurers, a segment of the P&C M&A market perceived as "hot," have increased over the last several years, they tend to be smaller deals in terms of transaction value and, accordingly, do not meaningfully affect deal value scorecards—The Hartford's 2018 acquisition of Navigators (\$2.1 billion) being a notable exception. Consistent with these observations, only two P&C legal entity acquisitions were announced last year with a deal value exceeding \$1 billion: Tokio Marine Holdings' agreement to acquire Privilege Underwriters, Inc., which does business as PURE Group (\$3.1 billion); and American Family Insurance Group's acquisition of Ameriprise Auto & Home (\$1.05 billion). Almost, but not quite, gaining admission to the \$1 billion club was CopperPoint Insurance Companies, a Western-based regional workers' compensation and commercial insurance company, which announced its agreement to buy Alaska National Insurance Company, a workers' compensation company, in September (\$900 million).

A property/casualty transaction that received considerable attention last year was the acquisition of the public float of EMCI by its 54% equity owner, Employers Mutual Casualty Insurance Company, an Iowa-domiciled mutual. The transaction was notable for two reasons. Going private transactions in the insurance industry are relatively rare. The only recent significant precedents are the acquisition of AmTrust (announced in 2018) by affiliates of Stone Point Capital, Barry D. Zyskind, AmTrust's Chairman and CEO, and members of the Karfunkel family. The other recent precedent was announced in 2016 and involved

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the acquisition of the public float of National Interstate, an affiliate of American Financial Group, by AFG. The EMCI going private transaction provides a road map for how an independent and sophisticated special committee of a subsidiary board with the procedural protections afforded by a “majority of a minority vote” can effectively negotiate with an acquirer that owns a controlling interest in the target.

The transaction is also interesting from a historical perspective. Thirty years ago, prior to the widespread adoption of legislation permitting the formation of mutual holding companies, only limited options—mainly the issuance of surplus notes—were available to mutuals for raising equity capital. Accordingly, many mutual property/casualty insurers formed P&C subsidiaries that entered into pooling arrangements with their mutual parents. While the parent and subsidiary boards typically included a number of independent directors, the officers and employees were typically identical. These downstream companies would then conduct an IPO and offer a minority interest to the public. In their heyday a large number of these companies with a public float existed. Today, only two remain.

iii. Financial Sponsors and Insurance M&A

The continued and increasing involvement of private equity and other financial sponsors in insurance-related transactions continues to be a trend to note. In their search for attractive assets, insurers have remained of interest to such investors. In particular, as demonstrated by the Carlyle/AIG transaction noted above, larger PE groups with their significant asset management capabilities across asset classes continue to be attracted to insurance acquisition opportunities—particularly those insurers with large fixed annuity and life insurance reserves.

As PE-backed transactions become more commonplace, the related regulatory approval process is becoming easier to navigate, both for the regulators and the PE fund sponsors. In the U.S., the insurance laws of each state require an acquirer of “control” of an insurer domiciled in that state to obtain a regulator’s prior approval, which requires the regulator to ensure that the policyholders are protected. The

business plans that are submitted in connection with the acquirer’s change of control filing may look quite different for a PE-backed deal compared to a more traditional strategic buyer. Some of these differences may result from the incorporation of leverage into the capital structure of the acquisition vehicle. The terms of affiliate agreements such as investment management agreements, reinsurance agreements and administrative services agreements that may be entered into in connection with the transaction will also need to be disclosed and approved or not disapproved. Notwithstanding the increased familiarity of PE buyers and regulators, the allocation of regulatory risk continues to be one of the more heavily negotiated provisions of the acquisition agreement—particularly with respect to defining red lines with respect to the capitalization of the acquired insurer.

iv. Subscription Rights-Sponsored Demutualizations

For many years several states have had legislation on the books permitting a mutual insurance company to convert to a stock company by providing rights to policyholders to subscribe for shares of the demutualizing company in lieu of the more traditional distribution to policyholders of their allocable share of the demutualized company’s surplus in the form of stock or cash proceeds from a sponsored demutualization. Most of these so-called “subscription rights” demutualizations have involved quite small insurers, many of which are Pennsylvania-domiciled. Vericity is a larger company that has proved to be the exception to this rule. In August it announced the completion of its initial public offering. The IPO was conducted in connection with the conversion of Members Mutual Holding Company from mutual to stock form and the acquisition by Vericity of all of the capital stock of Members Mutual following its conversion. As a result of the conversion, Vericity became the holding company for converted Members Mutual and its indirect subsidiaries, including Fidelity Life Association and Efinancial.

In the IPO 20.125 million shares were offered on a first priority basis to eligible members of the mutual holding company and on a second priority basis to the holding company’s directors and officers. In addition, Vericity,

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Apex Holdco and a fund advised by PE firm J.C. Flowers entered into a standby stock purchase agreement pursuant to which Apex and the Flowers-affiliated fund agreed to act as standby purchaser for shares to be offered in the IPO. In connection with the IPO approximately 3.5 million shares were subscribed for and Apex and Flowers purchased approximately 76.5% of the outstanding shares as standby purchaser. We note that subscription rights demutualization structures have from time to time excited comment from observers because of the substitution of subscription rights in lieu of the more typical distribution to policyholders of their allocable share of the demutualized company's surplus in the form of stock or cash proceeds. It will be interesting to see if the Vericity deal is the start of a trend or is an outlier.

v. Deal Points

Last year we observed an increased interest in locked-box purchase price structures and would like to offer our thoughts on the efficacy of a fixed-price transaction.

Most U.S. private company M&A transactions continue to provide for post-closing true-ups based on changes to the target's book value between a pre-signing reference balance sheet date and closing. While the terms vary, book value (usually statutory capital and surplus) is adjusted to conform to the actuarial appraisal, which is often used as the starting point for bidders' valuation models. These adjustments typically include or exclude certain balances such as asset valuation reserves or net deferred tax assets as well as unrealized gains and losses on certain assets (e.g., those supporting capital and surplus) in a manner consistent with the actuarial valuation. Changes in the adjusted book value between the reference balance sheet date and the closing date capture the earnings and losses generated by the business. Through the closing true up, the seller benefits to the extent the business generates profits and the buyer benefits to the extent that the business generates losses between the reference date and the closing. These post-signing profits and losses can be significant in an insurance deal, where the regulatory approval process can result in a deferred closing that occurs many months after the bidder's valuation and signing of the deal. However, for

certain lines of business the calculation of adjusted book value can be complex and because of the elasticity of the interpretation and subjectivity in the implementation of the applicable accounting and actuarial principles, disputes between the parties in calculating closing date book value have become increasingly common.

An alternative purchase price structure is the "locked-box." This structure, which has wide acceptance among U.K. and European insurance M&A dealmakers, does not adjust the price for changes in book value. Rather, prior to the signing the parties agree to a price which will often reflect the modeled earnings through an anticipated closing date or alternatively an interest surrogate for such earnings which is applied to the fixed price through the closing. In order to ensure that the buyer can protect the benefit of its bargain, the purchase price would be reduced for any so-called "leakage"—essentially non-ordinary course diminutions in value due to the actions of the seller (e.g., dividends and payments to affiliates). For the same reason, the interim operating limitations on the conduct of the business between signing and closing may be more restrictive in a locked-box structure than a more conventional book value adjustment structure. That being said, the locked-box may offer benefits to certain types of buyers (e.g., financial sponsors who may require greater certainty regarding funding requirements) and sellers for whom certainty of the closing price may also be important. Until recently locked-box transactions have been relatively rare in the U.S. insurance M&A market. In practice, defining "leakage" can offer some of the same complexity as calculating adjusted book value—particularly in the context of large complicated carve-out transactions. That being said, for less complicated transactions a locked-box structure can result in more streamlined execution and fewer post-closing disputes. As a result, we are observing an increased willingness among U.S. insurance dealmakers to consider locked-box transactions.

vi. Insurtech

We did not want to close out our summary without a brief note on insurtech in 2019. Reflecting the insurance industry's embrace of technology to drive underwriting,

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claims processing and distribution efficiencies, last year was another active year for insurtech transactions. According to industry sources, through the third-quarter deal volume (both M&A and capital raising) was significantly ahead of 2018's strong levels with high levels of participation on the part of financial purchasers as well as insurers. A prime example of the latter was Prudential Financial which, in September, announced its agreement to acquire insurtech firm Assurance IQ Inc. In that transaction Prudential agreed to pay total upfront consideration of \$2.35 billion plus an additional earnout of up to \$1.15 billion in cash and equity, contingent upon Assurance achieving multiyear growth objectives. According to Prudential's press release announcing the transaction, Assurance matches buyers and customized solutions spanning life, health, Medicare and auto insurance, giving them options to purchase entirely online or with the help of a technology-assisted live agent. The transaction will add an established direct-to-consumer channel to reach into the mass market.

B. Europe and the U.K.

i. Introduction—Europe/U.K. M&A

We noted in last year's edition of our insurance industry review that M&A activity in Europe had been muted as compared to the U.S., in part driven by uncertainty related to Brexit and the continued constraints on capital flowing from significant loss events of both 2017 and 2018 without a related material increase in insurance premium rates.

2019 saw a return to European deal-making due to the following themes:

- most insurers had implemented their Brexit planning strategies by the early part of 2019 allowing their businesses to refocus on other strategic business needs;
- the Lloyd's 'Decile 10' initiative refocused Lloyd's insurers on the need in many cases to either update their strategies or to leave the market altogether; and
- a recurring theme of focusing on the key areas of their insurance business has led to continued activity in the runoff space in Europe (and in particular the U.K.).

Although there was some hardening in rates across lines in 2019, businesses continued to seek to maximize shareholder value by exploring other strategic alternatives. Many insurers concluded that disposing of businesses in runoff to a specialist runoff provider is a sensible step to take as part of this process.

In 2020, we expect these themes to continue, with global insurers continuing to think creatively about strategic acquisitions in order to grow and maintain their shareholder value in what remains a lower-growth or flat rating environment and an uncertain European and global economic environment.

ii. Lloyd's M&A

M&A activity in Lloyd's in 2019 was a tale of two markets:

- activity increased as large players sought to double down on their Lloyd's strategies, recognizing the opportunities available to them by being large players in the world's biggest (re)insurance market; and
- a number of departures from the market occurred, particularly from smaller players.

The industry loss years of 2017 and 2018 led to introspection and a renewed commitment from the Lloyd's leadership to modernize and address perceived strategic shortcomings. In this modernizing context, the market returned to profit in 2019, with many participants confident that Lloyd's future plans will be successful and it will continue to lead and provide a rich ecosystem as part of the global and European (re)insurance market.

The drivers of the larger M&A deals at Lloyd's were existing players seeking to expand their footprint in the market and to achieve economies of scale that could not be as quickly achieved through organic growth. For example, Canopus, under its new private equity-backed ownership, continued to pursue its Lloyd's strategy with its acquisition of AmTrust at Lloyd's. The acquisition expanded Canopus's underwriting expertise and Canopus Chairman Michael Watson noted that the acquisition was "transformational in our determination to build a leading Lloyd's franchise."

I. Review of M&A Activity

Another important example of this transformational approach can be seen in Hamilton's acquisition of Pembroke, with Hamilton CEO, Pina Albo, noting the transaction "catapults us in the specialty space much higher, and allows us to build our reinsurance franchise."

Other acquisitions recognize the capital diversity on offer at Lloyd's, particularly in attracting third-party capital. Arch's acquisition of the Barbican group is a key example, with Arch noting in the press that its aim is to focus on growing its partnerships with third-party capital providers following the acquisition.

These consolidations were not the only factor contributing to a decrease in the overall number of Lloyd's market participants. Following two years of losses in 2017 and 2018, last year saw a number of departures from the market. The reasons given for Lloyd's closures varied, and many resulted from the review of lower Decile 10 markets, but key themes included the cost of participating in Lloyd's for smaller managing agencies and syndicates. The competitive landscape of Lloyd's for smaller participants is increasingly difficult in the face of the consolidation noted above with the larger players gaining more scale. For strategic acquirers, investors looking to exit the market can provide a good opportunity to establish a dedicated platform in the Lloyd's market (see for example the acquisition by runoff specialist Premia from Charles Taylor and The Standard Club of Syndicate 1884, which was placed into runoff as a result of the challenging environment noted above).

The year 2019 also saw the departures of Pioneer Syndicate 1980, Vibe and Acappella from Lloyd's. And in the first week of January 2020, Neon—backed by American Financial Group—announced that it too was withdrawing from the Lloyd's market following an attempted sales process earlier in 2019. These trends could signal that financial backers, rather than strategic acquirers, are hesitant about investing in dedicated Lloyd's vehicles at this time, despite the optimism regarding future changes to the Lloyd's operating and regulatory environment. See Section VII.E.vii below.

iii. Runoff M&A

We noted last year that the European market continued to be engaged in transactions aimed at managing (re)insurers' legacy exposures. This trend appears to be here to stay and continued apace in 2019 and early 2020. In an interest rate environment where insurance groups continue to search for opportunities to maximize shareholder value, runoff transactions have become a key part of the business strategy. By selling off legacy exposures, insurance groups can crystalize their exposures allowing them to reinvest capital or enabling capital release to shareholders as well as allowing them to focus on their core business areas.

In addition, many of the large players in the runoff space are now well-known to insurance groups and their confidence in using runoff providers for their legacy books has increased over time. Legacy and established vehicles such as Armour, AXA Liabilities Managers, Enstar, Catalina, DARAG, Premia, R&Q, RiverStone and Compre have been active in signing transactions during the past 18 months and many are raising funds for future deals. Consequently we expect that the runoff market will continue to thrive in 2020 and beyond. In another good sign for the runoff space, we have seen the number of bidders participating in the early stages of runoff transactions increase, reflecting the number of newer runoff providers who have now entered the space. Fortitude Re, the group founded on a book of legacy AIG business that has now been acquired by a Carlyle-managed fund and T&D, is a notable example of a new entrant to this market.

iv. European Life Insurers

A number of the large European M&A transactions have been in the life space and reflect recent trends for life insurers to seek realignment or consolidation. Of particular significance, Swiss Re and Phoenix Group announced in December 2019 that they had reached an agreement for Phoenix to acquire ReAssure in a £3.2 billion transaction. This transaction also tracks the theme of consolidation of runoff insurers. ReAssure had previously pulled its proposed listing on the London Stock Exchange, with the alternative sale to Phoenix reflecting the particular value a

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life runoff business has as a strategic asset compared with value as a stand-alone entity for public equity investors.

Prior to announcing its acquisition by Phoenix, ReAssure had agreed to purchase Quilter's wholly-owned subsidiary, Old Mutual Wealth Life Assurance Limited, helping to finalize Quilter's withdrawal from its life assurance business to focus on its core arms of financial advice and wealth management.

As noted in our U.S. and Bermuda M&A section, several large portfolio transfers occurred in relation to European life books, reflecting insurers' appetite to dispose of non-core portfolios and to focus on their key business areas.

v. Brexit in M&A Planning

As noted, 2019 was the last chance for many (re)insurers to finalize their Brexit plans. Lloyd's carriers have been making use of the Lloyd's Brussels platform, but for the wider market, various approaches have been taken. In the early part of 2019, several insurance groups finalized transfers of their European business to European subsidiaries (including Markel, Fidelis and Standard Life). This trend for portfolio transfers out of the U.K. in preparation for Brexit came to an abrupt end at the end of the first quarter of 2019, reflecting the focus of insurance groups on the original Brexit deadline of March 29, 2019.

Following the U.K. general election, it has now become clear that the U.K. will finally be leaving the E.U. and Brexit will become effective on January 31, 2020. However, during a transition period lasting until December 31, 2020 all arrangements between the U.K. and E.U. will continue to apply unchanged, thus giving both U.K. and European (re)insurers the chance to road test the implementation of their contingency plans. This transition period is likely to provide the period of stability that many in the market have been looking for during the past few years, which in turn may enable the current buoyant M&A market to continue in 2020.

II. Developments in Corporate Governance and Shareholder Activism

II. DEVELOPMENTS IN CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM

The year 2019 included a memorable insurer proxy fight, some new developments in shareholder activism, and a noteworthy shift by certain insurance companies on an important environmental, social and governance (“ESG”) issue. Our report, on these topics and more, follows.

A. Proxy Contests

As our readers know, proxy contests involving insurers can bring into play unique issues and defenses under the insurance holding company acts of U.S. states. Insurance holding company acts require persons who are presumed to have “control” of an insurer to file change of control approval filings or to “disclaim” control before acquiring the rights that create a presumption of control. Although the existence of actual control is a question of facts and circumstances, a significant fact for many insurance regulators is having a representative on the board of directors of an insurance holding company. Further, in some states a presumption of control is created merely by holding proxies covering more than 10% of the outstanding shares of an insurance holding company.

These state laws played a role, though perhaps not the decisive one, in bringing to an unsuccessful end Round 1 of Voce Capital Management’s 2019 assault on Argo Group. Round 2, however, was more satisfying to Voce.

To start from the beginning, in February 2019, Voce filed a Schedule 13D announcing that it had acquired 5.6% of Argo’s common stock, and that it had held discussions with Argo “concerning opportunities ... to enhance shareholder value.” Voce quickly followed this filing by nominating four candidates for election to the Argo board, coupled with an activist campaign by Voce objecting to Argo’s expense control and board oversight. Some of Voce’s accusations, in its “fight” letters, about the personal hobbies and expenses of Argo’s then-CEO were quite sensationalistic, including

implications that Argo sponsored a team in an around-the-globe ocean sailing race so that its CEO, an avid sailor, could participate in the race. In a complex board election fight, Voce eventually proposed five nominees for Argo’s 13-person board. The fight was complicated by maneuvering undertaken by Voce to try to seat five directors, given that Argo has a classified board of directors; Voce proposed to unseat directors who weren’t up for election and replace them with its own nominees.

Argo eventually gained the support of the influential shareholder advisory firm Institutional Shareholder Services (“ISS”) for its slate, which recommended voting against Voce’s nominees and for Argo’s. Leading up to the shareholders’ meeting, it appeared that the vote count was running in Argo’s favor. Then, shortly before the meeting, Voce withdrew its nominations. Notably, in its withdrawal press release, Voce stated that it had been advised by insurance regulators in Illinois and Virginia, two of the five states in which Argo’s U.S. insurance subsidiaries are domiciled, that proceeding with its proxy fight would violate state insurance holding company acts and that the regulator would “pursue injunctive relief and/or seek the voiding of any proxy votes cast” were Voce to continue. Voce described this state intervention as a “flip-flop,” motivated by Argo’s entreaties to the state regulators, and claimed that Voce had previously obtained “approval” for its proxy solicitation. Voce did not explain what it meant by “approval,” though it seems probable that if Voce had received formal regulatory approval for a change of control, it would have said so. Absent that, all that Argo needed to establish was that holding enough proxies to elect five members of a 13-person board, or actually causing such an election, would constitute “control” for insurance holding company act purposes. It appears to have succeeded, at least in two of the five relevant states.

Round 2 of the Argo battle, however, worked out better for Voce. In October, Argo announced that the Securities and Exchange Commission had issued a subpoena seeking documents relating to perks for its executives, digging into some of the expense issues Voce had cited. (One can only wonder if Voce had some role in stimulating the SEC’s curiosity, as Argo apparently did with the state regulators.)

II. Developments in Corporate Governance and Shareholder Activism

Soon thereafter, in a surprise move, Mark Watson retired as CEO, effective immediately. Meanwhile, Voce returned to the fight, commencing another proxy battle. In December Argo finally compromised, putting one Voce nominee on its board to fill the spot vacated by Watson, and agreeing to nominate an additional independent director from a list of three to be proposed by Voce, and giving Voce the right to select a third nominee from a short list of independents proposed by Argo.

The key takeaway from the Argo situation, as a U.S. legal matter, is that the insurance holding company acts remain an effective deterrent, in the right circumstances, to an activist. The final settlement appears to be watered down enough to be likely to pass regulatory muster.

B. Developments in Proxy Access

Proxy access refers to the ability of shareholders to include their own candidates for election to the board in the issuer's annual proxy statement. Proxy access does not mean that insurgent candidates will necessarily be elected; rather, it is intended to reduce the costs of running a proxy fight by allowing proponents of board candidates to avoid the costs of printing and distributing their own proxy statements. (For example, Voce mailed its own proxy materials in its fight against Argo; its final agreement with Argo includes \$1.75 million in expense reimbursement for Voce, an amount that is unlikely to have repaid Voce's costs in full.) In 2011, the SEC's proposed proxy access regulations were vacated by the Federal courts. The SEC's proposed rule would have permitted holders of more than 3% of the company's stock, who had held such stock for at least three years, to nominate up to 25% of the company's board (a "3/3%/25%" formula). However, in the wake of that proposal, shareholder activists began to seek so-called "private ordering" solutions to proxy access, in which issuers would adopt their own rules allowing access to the issuer's proxy statement, generally through a bylaw amendment. Although activist interest in this topic was initially limited, in 2015 and 2016 proxy access proposals boomed. According to Georgeson Inc. ("Georgeson"), approximately 200 such proposals were presented to

S&P 1500 companies in 2016, although a smaller number actually came to a vote.

However, in 2017 and 2018 the number of proxy access proposals declined, and in 2019 it fell even further. This decrease is attributable to the adoption by many large companies of a form of proxy access, as well as to the NYC Comptroller's Office in particular slowing the pace of its shareholder proposals on the topic. According to Georgeson, only five companies in the S&P 1500 presented shareholder proposals to enact proxy access in 2019, compared to 61 in 2016. Of these five proposals, three received majority support, including one at insurer Old Republic International. Further, only 22 companies presented proposals from shareholders seeking changes to a previously adopted proxy access measure in 2019, compared to 30 in 2018. These so-called "fix-it" proposals generally seek changes in some of the core features of proxy access, such as the percentage of the board that can be elected through proxy access (with proponents often seeking 25% of the board, rather than the 20% of the board that has become the standard under issuer-sponsored proposals) and the number of holders whose shares can be aggregated to reach the 3% ownership threshold included in many companies' bylaws. (On the latter point, most bylaws limit the number of holders that can be aggregated to 20, while activist shareholders generally ask that this number be increased to 40 or 50, or that there be no such limit at all.) The good news, from the standpoint of issuers, is that fix-it proposals do not seem to attract much support. None of the 52 total proposals voted on in 2018 or 2019 received a majority of the shares voted. In 2019, the average vote in favor was 22.0% of all shares voted. Proxy access today seems unlikely to be broadly adopted by smaller public companies.

For insurance holding companies, proxy access raises additional issues not present for many other types of issuers, such as the regulatory approval issues described above. Insurers implementing proxy access would be well-advised to require that any nominee obtain all necessary regulatory approvals for board service, and to build such a requirement into their relevant bylaw. Insurers should also require that to be eligible to use proxy access, the

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shareholder should have acquired its shares without the intent to change or influence control of the company, and that it not presently have such intent. This requirement is common in company-adopted proxy access provisions, and is based on a provision included in the SEC's abandoned proxy access rule. It pays heed to the same issues that appear to have tripped up Voce.

To date, it appears that, despite the support among investors for the adoption of proxy access, only one company has received a request for inclusion of a director candidate in the issuer's proxy statement that resulted in a nominee getting elected. In late December 2018, a holder of shares in The Joint Corp. (a provider of chiropractic care) filed a Schedule 14N nominating an activist investor who also holds shares in the issuer as a director candidate. This nominee was connected to one of the founders of the company. The shareholder nominee was elected after the company did not propose an opposing candidate for the relevant seat.

C. U.S. Say-on-Pay

As in the five prior years, in 2019 shareholders once again overwhelmingly voted in favor of executive compensation in U.S. companies' annual "say-on-pay" votes. According to Georgeson, only six companies in the S&P 500 received less than majority support for their executive compensation. Adverse recommendations by ISS and Glass, Lewis & Co. ("Glass Lewis"), the two biggest proxy advisory firms, once again greatly outnumbered failed votes. An additional 5.5% of S&P 500 issuers received favorable votes that were in the danger zone of from 50 to 70% in favor. (It is worth noting that Argo just barely passed its say-on-pay vote, with slightly more than 50% in favor. Query whether this outcome played any role in the speed of Mr. Watson's departure?)

In the U.S., pay ratio disclosure was first required to be disclosed in the 2018 proxy statement. This disclosure compared the total annual compensation of the company's CEO to that of the "median company employee," as determined under SEC guidance. These disclosures unsurprisingly showed a wide gulf between CEO pay and

median employee pay. In 2019, this gulf grew even wider, reaching 157:1 for the Russell 3000, up from 143:1 in 2018, in each case according to Georgeson. It remains to be seen what sort of shareholder proposals or impact on say-on-pay votes these disclosures may generate; to date, they seem more likely to emerge as talking points in the 2020 U.S. presidential race than anything else.

D. U.K. Say-on-Pay

Companies incorporated in the U.K. and with a London Stock Exchange listing are required to produce a directors' remuneration report containing a directors' remuneration policy, which is subject to a binding vote at least every three years, and an annual report on remuneration in the financial year being reported on, which is subject to an annual advisory vote. In 2019 a trend toward significant shareholder dissent over executive remuneration continued, as reflected in these votes. The Investment Association ("IA") has been researching the voting on remuneration over the last few years and found that a large number of FTSE All-Share companies had either their directors' remuneration policy or the report itself voted against by more than 20% of shareholders.

Andrew Ninian, Director of Stewardship and Corporate Governance at the IA stated that the IA's newly introduced database—Institutional Voting Information Service ("IVIS")—will assess all FTSE All-Share companies' remuneration policies against these principles before they are presented to their companies' AGM for a binding vote, and will provide a color code for their report to reflect the level of concern shareholders should have with the policy. Companies that see a vote of 20% or more against their remuneration policy, or pull their policy before a vote, will be added to the IA's Public Register, which is the world's first register tracking shareholder dissent at listed companies, and is publicly accessible on the IA's website.

In another executive pay development, the U.K. government introduced in June the Companies (Directors' Remuneration Policy and Directors' Remuneration Report) Regulations 2019, which implement the requirements of the Shareholder Rights Directive (2007/36/EC), as

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amended by Directive (EU) 2017/828, which came into force on June 10, 2019. The amendments, among other things, extend the scope of the U.K.'s existing executive pay framework to cover unquoted traded companies as well as quoted companies. Additionally, the date and results of the shareholder vote on the remuneration policy must be put on the company's website as soon as reasonably practicable and remain there for the life of the policy.

E. Other Corporate Governance Shareholder Proposals in 2019

The number of corporate governance shareholder proposals at S&P 1500 companies in the 2019 proxy season (not including proxy access) was lower than in 2018, continuing a multiyear trend. According to Georgeson, the number of such proposals fell to 209 proposals in 2019 from 229 proposals in 2018. As in prior years, shareholder proposals to eliminate classified boards, adopt majority voting for directors and eliminate supermajority voting provisions were the only types of proposals that usually received a majority of votes cast. However, the number of such proposals remained low, reflecting the extent to which these governance changes have already been adopted by the S&P 1500.

F. Environmental and Social Proposals

Environmental and social stockholder proposals continue to garner significant public attention. For the third year in a row, more environmental and social proposals than governance proposals were submitted to S&P 1500 companies, although fewer of the environmental and social proposals came to a vote. Most prominent among these are initiatives to address diversity, both among the employees and the directors of public companies, gender pay gaps, and political contributions by corporations. However, companies have shown an inclination to negotiate with the makers of such proposals, to avoid the negative PR associated with running them in the proxy statement. Many CEOs are sympathetic to their goals, while others do not want to see their companies mentioned in an unfavorable light with respect to issues such as diversity. In addition, board and employment diversity has grown very important

to institutional investors, particularly over the last two years. Large institutional investors have announced their support for board diversity, including BlackRock, State Street and Vanguard.

At the same time, the number of environmental proposals voted on declined in 2019 compared to 2018. However, many observers believe that this decline has resulted from larger institutional shareholders electing to engage with companies directly on these topics, rather than trying to effect change through voting. Direct engagement has boomed in the last decade, and anecdotal reports indicate that environmental issues are on the table at substantially all shareholder engagement meetings with large investors. Most large companies now produce some type of sustainability report, or include a discussion of sustainability in their proxy statements. This change has taken place in the last few years as well.

And the stakes keep getting higher. In early January 2020, in his influential annual letter to corporate CEOs, Larry Fink of BlackRock announced a number of initiatives to place sustainability at the center of its investment approach, including: making sustainability integral to portfolio construction and risk management; exiting investments that present a high sustainability-related risk, such as thermal coal producers; and launching new investment products that screen fossil fuels. In Mr. Fink's words, "[W]ith the impact of sustainability on investment returns increasing, we believe that sustainable investing is the strongest foundation for client portfolios going forward." His letter goes on to say that BlackRock will be increasingly inclined to vote against board members when their companies have not made sufficient progress on environmental disclosures and the business plans underlying them.

The insurance industry is very much under the microscope on these issues. Investors are increasingly concerned about the issue of deteriorating loss ratios resulting from climate change events. In one of 2019's significant developments, several large U.S. P&C insurers (including The Hartford, Chubb and Axis) announced that they would reduce their exposure to or eliminate the issuance of policies for coal producers or coal-powered plants. As reasons for this

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change, these companies have generally cited the reality of climate change and their commitments to be good stewards of the earth. These are worthy principles, but they also align with institutional investor objectives (including those of the “Climate Action 100 +” investor initiative) and other considerations, such as employee recruiting in today’s extremely competitive marketplace for talent. We anticipate that more U.S. insurers will join this movement in 2020.

G. Other 2019 Governance Developments

This section of our Year-in-Review would not be complete without briefly mentioning two more developments that affect the themes discussed above.

First, in November 2019 the SEC proposed two important sets of changes to its proxy rules (the “Proxy Rule Proposals”). The first set would provide additional regulation of proxy advisors such as ISS and Glass-Lewis. If enacted in their proposed form, these rules would, among other things, require the advisors to engage with issuers before publishing their advice, and disclose certain conflicts of interest. The second set of changes would increase the amount of issuer stock that a proponent must hold in order to have a proposal included in the issuer’s proxy statement, and make it harder to resubmit proposals that have not passed in prior years. These proposals have attracted considerable negative comments from shareholder activists, not least those who specialize in ESG proposals. Their concern is that such proposals may receive limited support one year but then very quickly become much more widely accepted. It is not clear whether the Proxy Rule Proposals will be enacted as written.

The second significant event was the publication in August 2019 by the Business Roundtable of a new “Statement on the Purpose of a Corporation.” This Statement, signed by 181 corporate CEOs, outlines a proposed “modern standard for corporate responsibility” that moves away from “shareholder primacy” toward a commitment to “all stakeholders—customers, employees, suppliers, communities and shareholders.” This Statement would put ESG principles more front and center to the mission of corporations than ever before.

Some commentators have wondered whether the Business Roundtable’s Statement is just “P.R.” or how it aligns with current requirements under state corporate law to focus on advancing the interests of shareholders. Others have asked whether any real progress will be made unless CEO compensation becomes linked, at least in part, to achievements not just on behalf of stockholders, but other “stakeholders” as well. (A small number of stockholder proposals in 2019 sought to link executive pay to sustainability goals; it will be interesting to see if that number increases in 2020.)

ESG advocates are waiting to see what the tangible results of the new Statement will be. Many of them believe that some skepticism is justified. And they perceive the irony that, shortly after the Business Roundtable published the new Statement, it reiterated its whole-hearted support for the Proxy Rule Proposals.

III. INSURANCE-LINKED SECURITIES

A. The Market Strikes Back

Insurance-Linked Securities, or ILS for short, is the name given to a broad group of risk-transfer products through which insurance and reinsurance risk is ceded to the capital markets. This group of products is continually evolving to meet market demand, and includes catastrophe bonds, sidecars, industry loss warranties, collateralized reinsurance and insurance-based asset management vehicles.

Drawn by low-correlated asset returns, particularly in a historically low interest rate environment, the amount of capital supporting the ILS market has grown considerably over the last decade as international pension funds, endowments, family offices and other large pools of capital have increased their investment allocation to ILS-dedicated asset managers.

Once a niche alternative to traditional reinsurance, ILS has developed into a mainstream source of insurance risk-taking capacity, often competing directly in or alongside traditional reinsurance catastrophe programs.

The establishment of ILS as a meaningful alternative and complement to reinsurance, however, was not an overnight process, but the hard and constant work of many individuals and organizations since the mid- to late- nineties. As in all things, the growth of ILS was not linear, but marked by distinct phases. The frequency and severity of catastrophe losses during each of 2017 through 2019 has seemingly brought about a new phase for ILS—what we would compare to the transition from adolescence to adulthood.

The poor performance of the asset class as whole for 2017-2019 has triggered significant redemptions at some of the largest ILS funds and resulted in an overall contraction of market capacity, as reported by reinsurance brokers. However, we believe that this contraction and other effects from recent events are part of a healthy and normal transition for the ILS market, which will ultimately benefit both buyers and sellers of risk-transfer protection. While

these market dynamics will continue to play out in the first quarter of 2020, we would like to highlight several important developments below:

- Recent losses have demonstrated that capital markets-based investors will pay claims in an orderly fashion like their reinsurance counterparts. This further establishes the underlying thesis and value proposition of ILS. Prior to 2017, the willingness of capital markets investors to pay significant losses was largely untested. Critics of ILS can no longer make that claim.
- Many ILS investors have exhibited greater pricing, modeling and underwriting discipline when participating in transactions, which we view as positive to the sustainability of the market over the long run. For instance, transactions with large unmodeled or undermodeled risks, particularly in annual aggregate structures, have been disfavored and have generally not fared as well. However, the overall deal pipeline remained robust, particularly for Rule 144A catastrophe bonds during the fourth quarter of 2019. In other words, deals got done, but underwriting still matters.
- Despite three years of elevated losses, risk transfer capacity has not returned to a “hard” market—at least not compared to historical precedent. While there may be a contraction of overall capital, and an increase in premium rates—particularly in certain pockets, such as loss-impacted cedants in Florida and the retrocession market—one should not confuse a return to rate adequacy with a hard market. In fact, one can make a strong case that ILS capital has been remarkably effective in 2019 in helping to smooth out the hard/soft market cycle previously exhibited by the reinsurance market post-catastrophe event.
- Although ILS fund redemptions have been an important story during 2018 and 2019, the reduction of capital has certainly not been universal across platforms. Instead, the market may see a much-needed differentiation of asset and reinsurance managers based on underwriting performance and whether the manager adds value across the risk-transfer chain. Some prominent asset managers have also entered the space, such as PIMCO. We believe

III. Insurance-Linked Securities

this differentiation is ultimately in the best interests of the industry.

- Many new sidecar transactions failed to materialize, and many existing sidecars struggled to remain flat year-over-year. As in any market, there are bright spots, but we believe those are the exception to the rule. We believe that sidecars are especially vulnerable to changing market dynamics given their exposure to higher frequency catastrophe events, such as California wildfires and typhoons.
- An important footnote to the 2019 events is the issue of “trapped” capital in collateralized reinsurance, sidecars and catastrophe bonds. In many of these collateral structures, the reinsurer is required to maintain capital at a multiple that decreases over time pursuant to a “buffer loss factor table.” These buffers could result in investor capital being tied up in a reinsurance trust for a considerable period of time, even though no actual losses are expected to the level of the buffers. While such buffers are common and agreed at the time of inception to account for reserve deterioration, this trapped capital has the potential to impact the overall capital in the market, lower ILS fund returns, and put added pressure on the terms of collateral release mechanisms.
- 2019 saw the issuance of special purpose insurers domiciled in Singapore, including for transactions sponsored by IAG, Safepoint and Security First. We view Singapore as a promising jurisdiction to “keep an eye on,” given the grant scheme established by the Monetary Authority of Singapore, but it will take considerable time and infrastructure to build a platform that rivals Bermuda. Singapore may be a viable alternative to smaller, cost-sensitive sponsors.
- At the end of 2019 and beginning of 2020, many reinsurers accessed the Rule 144A catastrophe bond market to purchase indexed-based retrocession coverage, including Axa XL, Everest, Hannover, RenRe and Swiss Re. The ILS market remained open as an important source of retrocessional capacity for traditional reinsurers, which will likely filter down through the reinsurance market.

In short, 2019 witnessed a return to normality, in which sources of risk-taking capacity were able to rebalance market dynamics and reassert underwriting discipline. We view this as a positive development for the long-term growth and development of the ILS market. However, it remains a big open question whether rate stability will hold up if there are large catastrophe losses in 2020.

B. U.K. ILS Framework

As a continuing trend, the PRA, backed by the U.K. Government, continues to note the importance of ILS to the U.K.’s competitiveness. As part of this ongoing initiative, in September 2019, the PRA launched a consultation process in connection with certain proposed amendments to PRA Supervisory Statement 8/17 “Authorisation and supervision of insurance special purpose vehicle” (the “Consultation Paper”). The Consultation Paper proposes reforms to provide clarity and to elaborate on the PRA’s approach and expectations in relation to the authorization and supervision of insurance special purpose vehicles (“ISPV”) and multi-arrangement insurance special purpose vehicles (“MISPV”). In the Consultation Paper, the PRA takes significant steps towards a proposed streamlining of the process, focusing on key information required, allowing for much needed flexibility in recognition of the commercial reality of “live” transactions and achieving cost and timing benefits. For example, the PRA acknowledges that the underlying transaction documents may not be fully executed prior to authorization of the vehicle and that certain commercial terms may remain outstanding and subject to negotiation up to settlement of the transaction. Consequentially, the proposed amendments would allow applicants to submit the fully executed underlying transaction documents after the regulatory approval has been granted.

Another proposed amendment would allow ILS market participants to leverage (to the extent possible and appropriate) work done in previous licensing applications, where the applications are sufficiently similar. Allowing the PRA to take advantage of learning derived from earlier applications will accelerate the approval of future

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transactions following the same blueprint, achieving cost and timing benefits, if approved.

One of the most anticipated amendments clarifies the PRA's approach with respect to the risk transfer and "fully funded" rules, in light of the ability for the risk exposure over the life of a transaction to vary at times, as is common for these transactions. Under the proposed amendments, the risk exposure must, as before, remain fully funded at all times. Since the risk exposure can change over the life of the arrangement, i.e., it can be increased for supplemental expenses or decreased for claims paid, the rules have always required that an ISPV clearly identify any features of the transaction that may cause the risk exposure to change. As part of the proposed amendments, the PRA further clarifies the kind of features it has in mind: deferral of premium payments; funding top-ups; delayed risk period inception; or mechanisms that allow rollover of funding between two consecutive risk transfer arrangements.

In addition, the Consultation Paper proposes amending the authorization and supervision rules to clarify the PRA's approach with respect to rollovers. The new wording, if approved, will make it clear that once certain criteria are met, the PRA considers that it should be possible to implement rollover mechanics under the U.K. ILS regime within the requirements under Directive (2009/138/EC) ("Solvency II") that ISPVs remain fully funded at all times. The important components of this is that the same funds should not be used to meet the collateral requirement of two consecutive risk transfer arrangements at the same time. But once the collateral requirement of the existing risk transfer is reduced and the funds equal to the value of such reduction are released, some or all of such funds can then be reinvested in the new risk transfer arrangement and be counted towards the fully funded requirement for the new risk transfer arrangement.

Willkie has provided a response to the Consultation Paper, in which we have expressed our support for the amendments generally, noting however that with respect to the amendments relating to rollover mechanisms, it would be helpful if the PRA could clarify its approach to "clawback." Clawback occurs when collateral is rolled from an existing transaction into a future transaction subject to the ability, if a late occurring loss or adverse development on losses arises on the expiring transaction, to repatriate those funds to the expiring transaction, by reducing the risk-exposure on the new transaction (or requiring investors in the new transaction to top up the funding in an amount sufficient to preserve the preclawback risk-exposure). The Consultation Paper does not comment directly on how the PRA may treat any clawback features with a rollover mechanism. Our response therefore requested clarification that clawback of any rolled over funds would be acceptable and within the "fully funded" requirement of Solvency II, once the same adjustments to the risk-exposure on the new and expiring transactions are made for any funds needed to be repatriated for late-developing losses or adverse development on the prior transaction.

The year 2019 has been a significant year for the U.K. ILS framework, which stands to benefit further from the proposed changes to make the regime more "market participant-friendly" and to align the features of the framework with some of the other established ILS jurisdictions, such as Bermuda or Guernsey.

IV. Excess Reserve Financings

IV. EXCESS RESERVE FINANCINGS

A. Summary of Deal Activity

The year 2019 continued the favorable trend started in 2016, as the number of new excess reserve financing transactions remained consistent with 2018. Prior to 2016, the number of excess reserve financing transactions was depressed by an abundance of caution from both regulators and insurance companies in the life insurance reserve financing market, in large part because of the NAIC Captives and Special Purpose Vehicle Use (E) Subgroup activities, and in particular the adoption by the NAIC of Actuarial Guideline 48 (“AG 48”) in late 2014 (as further described in subsection C. of this section below), which applies to all life insurance policies issued after December 31, 2014 that fall under Regulation XXX or AXXX.

In 2018 and 2019, the number of new excess reserve financing transactions increased due to an increased level of certainty as to what regulators will permit in current and future financings. In addition, the trend of restructuring existing transactions continued, as companies sought to take advantage of lower lending rates and the continued interest by reinsurance companies in acting as financing providers. Also, the use of a captive insurer to finance XXX and AXXX policies was bypassed by some companies, by adding admitted assets to the balance sheet of the insurer. Most insurers with a history of excess reserve financing transactions completed the process of addressing the complexities of AG 48 issues in late 2016 or early 2017, with many closing new transactions involving AG 48 covered policies, or adding a block of AG 48 policies to an existing transaction, in both 2018 and 2019.

i. AXXX Market Remains Open

As was the case in 2018, several recent transactions were designed to provide reserve financing for universal life policies subject to Regulation AXXX. In 2019, the expansion of lenders willing to provide financing to fund AXXX reserves continued the trend that started in 2012. In most transactions in both the XXX and AXXX markets,

commitments were for 10 to 25 years, although shorter terms intended to act as a financing bridge until other expected sources of funding become available are still commonly seen.

ii. Non-Recourse Transactions Remain the Structure of Choice

In 2014, prior to the effective date of AG 48, the vast majority of deals were secured by non-recourse letters of credit, contingent notes or collateral notes, as those transactions had essentially replaced traditional letters of credit among lenders and reinsurance companies active in the AXXX/XXX market. While for a time, in 2015, we saw a return to, or at least a heightened interest in, traditional letters of credit, the market has returned to the non-recourse contingent note structure, which remained by far the structure of choice in 2019. In the past, the obligation to reimburse the bank for any draw on the letter of credit was guaranteed by a parent holding company, thus being known as a “recourse” transaction. In a non-recourse transaction, no such guaranty is required. Rather, the ability to draw on the letter of credit or contingent note is subject to certain conditions precedent. These conditions typically include, among others, the reduction of the funds backing economic reserves to zero and a reduction in a prescribed amount of the captive insurer’s capital, and a draw limited to an amount necessary for the captive insurer to pay claims then due. Because of these conditions, lenders and other funding sources became more comfortable assuming the risk of relying for repayment on the long-term cash flows from a block of universal life policies. With the advent of AG 48, some regulators initially had approached a non-recourse transaction with added caution, where the proposed “Other Security” is a conditional draw letter of credit or a contingent draw note. Transactions completed in 2019 continued to show that many regulators recognize that this approach is not expressly forbidden by the new rules, and that these bespoke sources of contingent funding are acceptable under AG 48. Collateral notes (demand notes backed by pools of assets) may, but typically do not, contain these contingent features and therefore should

IV. Excess Reserve Financings

remain acceptable for financing under AG 48, at least as “Other Security.”

iii. Choice of Domicile for Captive Insurers and Limited Purpose Subsidiaries

Vermont and Delaware remained the preferred domiciliary jurisdictions for captive life insurers in 2019. Several states have adopted captive insurer laws or have amended and expanded existing captive insurer laws over the past few years to facilitate reserve funding transactions. Similar to 2018, additional states, including Arizona, Nebraska and Iowa, were being utilized as captive insurer domiciliary jurisdictions. As has been the case for the past few years, the use of “Limited Purpose Subsidiary” statutes in several states have cooled off and may not currently be the captive insurer structure of choice, at least for new AG 48 transactions. The exception appears to be Iowa, where Iowa-domiciled insurers continued to utilize the Limited Purpose Subsidiary law. The Limited Purpose Subsidiary (“LPS”) statutes permit a ceding company to form a captive insurer in the same domiciliary state as the ceding insurer, which has proven to provide for a more streamlined regulatory approval process for a transaction.

B. Utilized Structures

i. Limited Purpose Subsidiaries

We are not aware of any new transactions that closed in 2019 and that employed the use of an LPS law in a reserve financing transaction. Georgia, Indiana, Iowa and Texas have each promulgated an LPS statute. The advantage of an LPS over a captive insurer is that an LPS, once licensed, may provide its ceding company parent with full credit for reinsurance without posting any security in the form of a letter of credit or a credit for reinsurance trust. Under the LPS statutes, an LPS is permitted to take statutory financial statement credit for the face amount of letters of credit as well as parental guaranties by statutory authority; the LPS need not seek regulatory approval for a permitted practice or other dispensation to use this accounting treatment. Although this was a major development in the ability to finance Regulation XXX/AXXX reserves, we have not seen

the use of the LPS statutes take off as expected, likely as a result of the general caution on the part of insurers and regulators alike.

ii. Credit-Linked Notes and Collateral Notes vs. Letters of Credit

As mentioned above, recent activity in the marketplace implies that the use of contingent credit-linked notes in a role analogous to a “synthetic letter of credit” will continue, along with collateral notes, to be the structure of choice for excess reserve financing transactions. In the typical credit-linked note transactions, an SPV issues a puttable note to a captive insurer. The captive insurer’s right to “put” a portion of the note back to the SPV in exchange for cash is contingent on the same types of conditions that would otherwise apply in a non-recourse contingent letter of credit transaction. The use of these notes, rather than letters of credit, has provided a means for reinsurance companies, which contractually agree to provide the funds to the SPV to satisfy the put, to enter a market that was once only available to banks. In collateral note transactions, demand notes backed by pools of assets are issued by an SPV to a credit for reinsurance trust on behalf of the captive insurer. Collateral notes are typically rated and qualify as admitted assets. The assets that back the collateral notes can be provided by banks, reinsurance companies or other providers of collateral.

iii. Use of Excess of Loss Reinsurance as a Financing Source

The use of excess of loss reinsurance agreements as a reserve financing source, although utilized in the market for several years now, saw a continued resurgence in 2019, with several financing transactions choosing an XOL policy over a credit-linked note format. In an XOL transaction, the captive reinsurer and the XOL provider, usually a professional reinsurer or reinsurance affiliate of a financial guaranty insurance company familiar with credit-linked note transactions and reserve financings generally, enter into an XOL agreement whereby the captive reinsures mortality risk and the XOL provider assumes the captive reinsurer’s collection risk. The XOL provider pays claims

IV. Excess Reserve Financings

in excess of the economic reserve, or for a financing of policies under AG 48, the amount of "Other Security." The advantages of an XOL transaction over a credit-linked note transaction are the relative simplicity of the transaction structure and corresponding agreements, as well as a more familiar format to present to regulators. Because many of the same financing providers that participate in the credit-linked note market also offer XOL agreements as an alternative structure, we would not be surprised to see continued growth in XOL transactions in the future.

iv. Funding Sources Beyond Banks

As outlined above, the market for funding sources in XXX and AXXX transactions has expanded beyond banks in recent years through the use of contingent credit-linked notes, collateral notes and XOL agreements. Large reinsurance companies have shown a keen interest in participating in these transactions through support of the SPVs that issue the contingent notes and collateral notes and through the use of XOL agreements. With the expansion of the group of potential funding sources for these transactions, life insurance companies can seek more competitive pricing and terms. Although the past few years have shown a trend of reinsurance companies surpassing banks as the primary "risk taker" in these transactions, we note that in both 2018 and 2019 at least one bank actively and successfully entered this market as well as at least one financial guaranty insurer, which may portend the beginning of a resurgence by these companies in this market.

v. Use of Reserve Financing Structures on AG 33 Reserves for Fixed Annuity Contracts

The use of contingent credit-linked notes and XOL agreements expanded in 2019 to address the reserve strain experienced by the issuers of fixed annuity contracts due to the application of AG 33 reserves using mortality tables that generate excessively conservative reserve requirements. In these transactions, the liability in excess of the account value of certain fixed index annuity contracts with respect to guaranteed lifetime withdrawal benefits are reinsured to the captive reinsurance company and backed by either an XOL agreement or a credit-linked note structure. Although

not yet showing the same market attention as XXX and AXXX transactions, the need to finance AG 33 reserves has definitely caught the attention of several issuers of fixed annuity contracts as well as the reinsurance companies that provide financing for these transactions.

C. Regulatory Environment

We noted above the importance of the NAIC's adoption of AG 48, which was part of the NAIC action plan to develop further regulatory requirements with respect to XXX and AXXX transactions. The adoption of AG 48 in 2014 was followed by the NAIC adopting the Term and Universal Life Insurance Reserve Financing Model Regulation and an amended version of AG 48 in December 2016. Importantly, the Model Regulation and AG 48 aimed to set standards applicable to XXX and AXXX transactions, instead of restricting them outright.

For most states, the adoption of the Model Regulation will replace AG 48. According to the NAIC, as of November 1, 2019, only four states (i.e., California, Iowa, Virginia and Wyoming) had adopted the Model Regulation.

Prior to 2019, the NAIC engaged in discussions to determine whether the Model Regulation should be adopted as a Part A Accreditation Standard (which would have the substantive effect of requiring all U.S. states to adopt the Model Regulation within the next few years). At that time, this accreditation decision was deferred until the finalization of the changes that needed to be made to the Credit for Reinsurance Model Law (which authorizes state insurance departments to promulgate the Model Regulation) as part of the NAIC's response to the Covered Agreement between the United States and the European Union.

At the Fall National Meeting of the NAIC held in early December, the NAIC finally adopted the Model Regulation (titled "Model #787") as a new accreditation standard with a September 1, 2022 effective date. Model #787 establishes uniform, national standards governing reserve financing arrangements pertaining to XXX and AXXX policies, and closely follows the initial version of the Model Regulation

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and AG 48. The NAIC intends for each state to adopt the 2019 Amended Credit for Reinsurance Models

as a package with Model #787 to the extent any such state has not already adopted these models.

V. Developments in Longevity, Pension Closeouts and Derisking Transactions

V. DEVELOPMENTS IN LONGEVITY, PENSION CLOSEOUTS AND DERISKING TRANSACTIONS

A. Developments in Continental Europe

As in recent years, the Netherlands saw the most activity in Europe (excluding the U.K.) with respect to longevity transactions, with both VIVAT and Aegon reinsuring annuity liabilities with Canada Life (roughly €5.5 billion of in-payment and deferred liabilities for VIVAT and €12 billion for Aegon). Although we have not seen the resurgence of index-linked transactions that we had hoped for in last year's report, signs from the DNB (the Dutch financial services regulator) indicate a growing comfort with reinsurance as a risk-mitigation technique under Solvency II. In November 2019, the DNB published a final Q&A document on aspects which the DNB considers relevant for the recognition of reinsurance contracts in the Solvency Capital Requirement for insurers using the Solvency II standard formula. (The first draft of this Q&A document was published while the process for the sale of VIVAT was underway, which we surmise may be motivated by concerns that a purchaser would look to heavily reinsure its liabilities outside of the Netherlands.) This Q&A should be seen as helpful guidance from the DNB, and possibly as a sign of its increasing comfort with accepting well-structured transactions that are subject to sufficiently detailed governance reviews to hedge longevity risk.

Continuing the trend of previous years, 2019 was another record-breaking year for the U.K. longevity derisking market, with some estimates suggesting that transactions (including bulk annuities written by the same eight insurers as were quoting in the market in 2018) could reach £40 billion. This level of activity is likely to continue into 2020, including the completion of transactions held over from the end of 2019 when targets and capacity had been reached.

We noted last year that in 2018 several significant disposals of annuity back-books were completed. The year 2019 was instead a year of "jumbo" bulk annuities transactions. Of the

five largest buy-in or buyout transactions ever completed in the market, four were completed in 2019, largely dominated by Rothesay Life. A number of the larger transactions, as well as various smaller deals, include coverage for deferred pensioners. As discussed further below, we would expect the increase in the number of large bulk annuities deals—including in particular where such deals include deferred liabilities—to lead to increased demand for reinsurers offering to cover the market risk as well as the longevity risk.

Given the size of back-book annuity portfolios held by insurers, we expect to see further derisking and consolidation by way of back-book disposals, either via a Part VII portfolio transfer or an acquisition (such as the approach taken by Phoenix in its acquisition of Swiss Re's ReAssure in a cash-and-shares deal, giving Phoenix a further share of the market after its 2018 acquisition of Standard Life's insurance business). However, insurers will have to give due regard to the High Court's 2019 decision not to approve the Part VII transfer of an annuity portfolio from Prudential plc to Rothesay, despite the regulators having raised no objection and the independent expert having given his view that the transfer would have no material adverse effect on policyholders. This case is thought to be the first time that the court exercised its discretion to decline to approve a Part VII transfer against the views of the regulators and the independent expert. Under the statute, the court is granted broad discretion as to the matters it may consider, allowing it to approve the transfer if it considers it appropriate "in all the circumstances of the case." In previous judgments, the court's focus was on the security of the policyholders' benefits and the level of service the policyholders will receive after the transfer. In the Prudential/Rothesay case, the court took a broader approach, giving weight to additional factors such as the initial choice of annuity provider made by the policyholders, the respective reputations and longevity of the parties and the presumption that investor shareholders may not have as much motivation to provide further capital (as compared to a group company parent) if required to do so. The judgment came as a surprise to market practitioners and immediately cast a degree of doubt on the viability of future similar

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transactions. The judgment in the Prudential/Rothesay case, however, is being appealed, and a subsequent judgment later in 2019 relating to a transfer from Canada Life to Scottish Friendly gave more relative weight to other factors, giving hope that the Prudential/Rothesay case was more of a “one-off” and that the courts will follow prior practice of placing considerable weight on the independent expert’s report and the views of the regulators.

Another key trend that we witnessed in 2019 is the conversion of existing longevity swaps to buy-ins or buyouts. Given the large number of longevity swaps that have been entered into to date, we expect this trend to continue into 2020 as pension schemes continue on their derisking journey and the market continues to mature. Two such conversions in 2019 were the Rolls-Royce scheme’s £4.6 billion partial buy-in to buyout transaction with Legal and General (particularly notable for its size and the requirement to transfer an existing hedging portfolio as part of the conversion) and the Scottish Hydro Electric Pension Scheme’s conversion of a longevity swap with Legal and General to a partial buy-in by Pension Insurance Corporation (“PIC”).

The number of jumbo bulk annuity transactions in 2019 raises some concerns that smaller schemes could find it hard to get the attention of insurers; however, 2019 saw further availability of flow reinsurance and products such as Zurich’s “Streamlined” and Legal and General’s “Insured Self-Sufficiency” product, each of which hopes to further open the market to smaller schemes or those that are not ready to fully derisk. Such schemes could also be targeted by commercial consolidators, which were a key topic of discussions in 2019 due in part to the U.K. Government’s release of consultation papers relating to such consolidators at the end of 2018. Although two commercial consolidators have been announced to date (Clara-Pensions and The Pension SuperFund, each of which is backed by investors including private equity), 2019 did not see the first consolidator transactions, which were expected during the year—the U.K. Government did not introduce legislation setting out a bespoke regulatory regime (likely due to disagreement between the Treasury and the Department for Work and Pensions) and the consolidators are therefore

subject to the Pensions Regulator’s supervision. Both Clara-Pensions (which positions itself as being a route to a buyout) and The Pension SuperFund (which is not aimed at moving schemes to buyout but rather emphasizes the advantages of scale by pooling schemes to create one large occupational pension scheme) have reported the establishment in 2019 of strong pipelines for 2020, and The Pension SuperFund is awaiting the Pensions Regulator’s sign off on its first two deals. We would expect to see relatively little action from either of these consolidators until legislation is introduced, as cautious trustees are likely to want to see what the regulatory landscape looks like before making a firm decision.

Following a relatively quiet 2018 for the “captive” longevity-only reinsurance market (where we initially reported no transactions in 2018, although a late announcement in February 2019 confirmed that two longevity swaps for LaFarge U.K. Pension Plan covering around £2.4 billion of liabilities were reinsured to Munich Re via two incorporated cells of a captive insurance vehicle in August 2018), 2019 marked the comeback of the “jumbo” captive transaction. In August 2019 the U.K. pension scheme of HSBC Bank entered into a £7 billion longevity swap transaction covering half of the pension scheme’s pensioner liabilities with The Prudential Insurance Company of America (“Prudential”). The risk was transferred from the pension scheme to Prudential via HSBC’s captive insurer in Bermuda. The transaction was the first to use Bermuda as the jurisdiction for the captive (as previous captives transactions all utilized vehicles in Guernsey) and marks the second-largest longevity transaction ever for a U.K. pension scheme, behind the £16 billion transfer by the BT Pension Scheme to Prudential in 2014.

It will come as no surprise that demand for longevity reinsurance from the bulk annuity insurers remains at an all-time high. In June 2019, PIC confirmed that the first half of the year had been record breaking, not only in terms of new bulk annuity business but also longevity liabilities reinsured. In the same announcement, PIC stated that more than 70% of PIC’s total longevity exposure was reinsured, across treaties signed with 11 highly rated reinsurance counterparties. In our 2018 report we observed

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and commented on an increase in the establishment of facility and master collateral and/or payment-netting arrangements between bulk annuity insurers and reinsurers. This trend has continued and transactions are becoming far more standardized and therefore, in some instances, simply viewed by the counterparties as “business as usual.” We believe this explains why fewer longevity reinsurance transactions are being announced publicly. We are aware of, and have worked on, a significant number of longevity reinsurance transactions that are not in the public domain and therefore excluded from the statistics cited by market commentators. New reinsurance relationships are also still being established. In August 2019, Prudential announced that it had entered into a new longevity arrangement, whereby Prudential will provide longevity reinsurance capacity to The Phoenix Group. The year ended with an announcement that Zurich and Hannover Re entered into an £800 million longevity swap for an unnamed U.K. pension fund of a FTSE 100 company.

The year 2019 has also been the year of innovation. As predicted in our 2018 report, the market is expanding through entry of new third-party capital and transactions that allow insurers to transfer market risk as well as longevity risk (known as “funded reinsurance” or “funded re”). We are aware of a number of funded reinsurance transactions executing in 2019, including an announcement by Athene Holding Ltd. that it closed its inaugural U.K. transaction on December 19, 2019 through its wholly owned subsidiary in Bermuda, Athene Life Re International Ltd. We were not surprised by this announcement given the level of interest we are seeing in the U.K. market from U.S. reinsurers, who are able to bring different asset classes and funding to the market than European participants. At a time when more deferred pensioners are being insured than ever before, reinsurers will be motivated to take the asset risk associated with these longer-term liabilities through the provision of funded reinsurance. Continuing on the topic of innovation and third-party capital—Securis Investment Partners LLP (“Securis”), the insurance and reinsurance linked investment manager, announced that it had closed a unique longevity hedge for a prominent life risk carrier in 2019. The hedge covers an in-force longevity

transaction written by the carrier and has been structured to include a transformer reinsurer and recourse to Securis as part of the security package. It offers an indemnity hedge as opposed to the typical “index-linked” structure, which is more common with life insurance investors. This development is encouraging and demonstrates willingness on the part of ILS investors to participate in transactions with a longer duration. In another transaction, a prominent life reinsurer accessed third-party capital to support an existing block of longevity business through the financing of an offshore special purpose vehicle using a financial instrument that, in a transaction of this nature, is unusual and novel. The transaction has advantageous capital and ratings consequences for the reinsurer.

We noted in last year’s report that the PRA has indicated that it will not review the risk margin until there is a clear position on Brexit and the post-Brexit relationship with the E.U. In October 2019, EIOPA published a consultation paper in response to a call for advice for the 2020 review of Solvency II (see Section VII.E.vi below for further discussion of this), with the aim of publishing its final advice in June 2020. The consultation paper proposes no changes to the risk margin, despite its acknowledged interest rate sensitivity. Following Brexit, we may therefore see increased pressure from insurers for a U.K.-specific solution to the risk margin problem.

In early 2019, the PRA issued a consultation paper on proposals to simplify the notification requirements on relevant U.K. authorized firms buying or selling longevity protection, which resulted in an update to its Supervisory Statement SS18/16 (*Solvency II: longevity risk transfers*) in January 2020. Firms will no longer have to notify the PRA of all longevity risk transfer and hedge arrangements in advance of the completion of any transaction, but will instead only have to give advance notification of “new large and/or complex” arrangements (which are defined as those which have a larger value/financial impact or more complex structure than would be transacted on a business as usual basis, or which have a material incremental impact on the firm’s ability to meet its SCR). For other transactions, the PRA expects to be notified (by way of the firm filling in a reporting template) shortly after the reinsurance has been

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placed. The template includes details of the counterparty, the form of transaction and risks transferred, its effective date, the notional liability transferred, the notional liability covered by collateral, the collateral mechanism and details of eligible collateral assets, plus a section for other features of note (for example, whether it is related to a Part VII transfer) and a note that firms should discuss additional features (e.g., complex splits with asset risk) with their supervisory contact. The PRA's stated intention, apart from making the process less time-consuming for smaller transactions, is to allow the PRA to gain a fuller picture of the market and the potential buildup of risk concentrations, including counterparty credit risk, and to better supervise firms' management of such risks. The PRA also took the opportunity to remind firms of the importance of giving due regard to residual risks, including in particular basis risk caused by divergence in terms between the front-end and back-end contracts. It is clear from this that the PRA continues to be focused on the possibility of concentration risk among reinsurers in the longevity market.

B. Developments in North America

Turning to North America, the U.S. market continued to expand in 2019. Approximately \$25 billion in U.S. pension liabilities were transferred in 2019. This total falls just shy of the \$27 billion transferred in 2018. Despite this small decrease in total volume, the number of deals exceeded 2018's total. A survey conducted by LIMRA found that by the end of the third quarter, 301 group annuity contracts had been sold—up from 281 over the same period in 2018. When viewed from this vantage point, the anticipated transfer of \$25 billion in liabilities is more impressive because 2019 did not see an exceptionally large jumbo deal on par with 2018's \$6 billion transaction between MetLife and FedEx (which, as we noted in our March 2019 review, was the largest deal executed in the U.S. market since Prudential Financial's 2012 transactions with General Motors (\$25 billion) and Verizon (\$7.5 billion), respectively).

As we have previously noted, the U.S. market has been moving away from jumbo deals toward smaller and midsize deals. The market's performance in 2019 reflects that trend as well as the continued interest among plan

sponsors in pension risk transfer specifically and derisking more broadly. Indeed, several deals reported this year were executed after the plan sponsor had already taken action to freeze plan benefits, offer lump sum payouts to participants, or both, in order to define and reduce the block of pension liabilities before transferring them to third-party insurers. This underscores the role played by pension risk transfer as an element of the larger, incremental strategies that plans are employing to derisk. While some commentators predict that the U.S. market may cool in the coming years because those plans best positioned to execute pension risk transfer transactions have (or will have) done so, interest among plan sponsors continues to be high. The biennial Mercer/CFO Research study published in June 2019 noted that 70% of plan sponsors are looking to execute a buyout transaction in 2019 or 2020. That total is up from 56% in 2017. We expect such interest to continue unless all of the factors currently incentivizing plan sponsors to derisk are removed, which is unlikely.

Principal among those factors are increased PBGC premiums and market volatility, particularly lower interest rates. PBGC premiums continue to rise: the per-participant rate for single-employer plans is \$83 in 2020 (up from \$74 in 2018 and \$35 in 2012). These increases were mandated by the 2012 Moving Ahead for Progress in the 21st Century Act, and are anticipated to continue on an annual basis. They have created a strategic need for plans to reduce the number of participants with lower monthly benefits because the premium for those participants, assessed per head, is disproportionately expensive (and as noted below, this year saw several transactions that transferred liabilities relating to participants receiving relatively small monthly benefits). However, pension risk transfers will ultimately decrease PBGC revenue as more plans shift liabilities to insurers (which, of course, are not required to pay such premiums). This result could pressure lawmakers to reduce or eliminate the premium increases given that the PBGC's multiemployer program announced a \$65.2 billion 2019 deficit and projected insolvency by 2025.

Declining interest rates have been another key factor spurring market growth as they have pushed plan sponsors to reduce their discount rates. In turn, lower discount

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rates have increased pension obligations and, despite the robust performance of the U.S. stock market, decreased funded status among U.S. plans. In addition, lower interest rates might also facilitate derisking by making it easier for plan sponsors to leverage the purchase of group annuity contracts. Such action is not without precedent: International Paper Co.'s 2017 purchase of a \$1.3 billion group annuity contract from Prudential was preceded by a \$1.25 billion contribution to the pension plan, funded in part by a \$1 billion debt offering. It is noteworthy in this respect that FedEx and UPS both announced in 2019 their intentions to use the proceeds of recent debt offerings to fund plan contributions. Market watchers expect such actions to continue if interest rates remain low, though their impact on the U.S. pension risk transfer market remains to be seen.

The U.S. market also witnessed a significant uptick in buy-ins in 2019. By mid/late November, \$888 million in buy-ins had been reported, the highest level to date. That amount represents a key milestone for the U.S. market, where buy-ins are not as common as they are in the U.K. A principal reason for this distinction between the U.S. and U.K. markets is PBGC premiums. In the U.S., as in the U.K., buy-in transactions offer a means of reducing the plan's risk, and in both cases, the plan will remain responsible for administrative costs. But in the U.S., those costs include PBGC premiums, which has historically made buy-in transactions less attractive to U.S. plan sponsors either as an interim stop before completing a buyout or as an end in itself. Buyouts, in contrast, eliminate the plan's responsibility to pay PBGC premiums and other administrative costs. The increase in buy-ins suggests that U.S. plans are more eager to use all potential derisking options and, we think, bodes well for the continued diversification of the U.S. market in 2020 and beyond.

Despite the trend toward midsize and smaller transactions, the U.S. market saw several large deals in 2019. The largest among them was the \$2.4 billion group annuity contract purchased by Baxter International from Prudential Financial. The deal, announced in October, transferred to Prudential the liabilities for approximately 17,200 retirees and former employees representing approximately 50% of Baxter's global pension liabilities. That transaction followed

Prudential's January 2019 transaction with Lockheed Martin Corporation covering approximately 32,000 retirees and \$1.8 billion in liabilities.

Athene was also busy in 2019. In October, it assumed \$200 million of liabilities from Bristol-Myers Squibb. That transaction completed the "first-of-its-kind" full plan termination between the two parties announced in December 2018. As we noted in our March 2019 review, the first portion of that transaction entailed Bristol-Myers Squibb's purchase of a \$2.4 billion group annuity contract from Athene following the payment of approximately \$1.3 billion in lump sums to plan participants. Athene also announced transactions with Weyerhaeuser Co. and Lockheed Martin in 2019. The former saw Weyerhaeuser transfer \$1.5 billion of U.S. pension liabilities to Athene following a lump sum offering to approximately 20,000 former Weyerhaeuser employees. Lockheed Martin executed a buy-in transaction with Athene under which the Maryland-based aerospace and defense company purchased an \$800 million group annuity contract covering pension liabilities for approximately 9,000 retirees while retaining responsibility for plan administration.

In last year's review, we noted AIG's intention to grow its presence in the pension risk transfer market following two plan termination transactions concluded in 2017. AIG successfully followed through in 2019 with the execution in April of a buyout transaction with Avery Dennison Corporation pursuant to which it assumed \$750 million in pension obligations covering approximately 8,500 retirees, beneficiaries and deferred and active members. AIG also concluded a transaction with global consumer and commercial services company Rollins, Inc. in October. Rollins, which froze its pension plan in 2005, transferred \$198.3 million of U.S. pension obligations to AIG.

Other noteworthy transactions include the transfer by Owens Corning in October of approximately \$89 million in pension liabilities to an undisclosed insurer. The transaction covers approximately 2,000 participants whose benefits are less than \$600 per month. Also in October, McKesson Corp. purchased a \$280 million group annuity contract from an undisclosed insurer following the distribution of

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approximately \$49 million in lump sums to about 1,300 participants. Arizona-based technology company Rogers Corp. terminated its U.S. non-union pension plan following a lump sum distribution of about \$39 million and the transfer of approximately \$124 million in liabilities via the purchase of a group annuity contract from an undisclosed insurer. Lennox International purchased a group annuity contract from Pacific Life covering approximately \$78 million in pension liabilities. The transaction follows actions taken by the Texas-based HVAC manufacturer to freeze its pension plan and distribute lump sum payments in 2016.

Shifting our focus to Canada, the Canadian pension risk transfer market experienced its sixth straight year of growth in 2018, doubling in size from 2013, and did not show signs of slowing down in 2019. Indeed, by the end of the second quarter 2019, the market saw C\$1.2 billion (\$925 million) in reported transfers. That level of activity is on par with 2018's results over the equivalent period.

Several factors have contributed to the growth of the Canadian market, including a stabilized pool of insurers and legislative changes in British Columbia, Ontario and Quebec that permit plan sponsors to fully transfer responsibility to insurers without retaining any residual risk. Part of the market's success has been attributed to the willingness and ability of plan sponsors and insurers to develop innovative, customized solutions to plan needs, including longevity risk transfer. It has also been reported that high funded ratios have also been part of this equation. Funded ratios reached an 18-year high in 2018, but have since declined as a result of decreases in longer-term Canadian bond yields.

While billion-dollar "jumbo" deals are not as common in Canada as they are in the U.K. and the U.S., market watchers have noted that the average size of annuity transactions has increased from about C\$29 million (\$22.2 million) in 2016 to C\$40 million (\$30.7 million) in 2018 and that larger transactions are becoming more frequent. Indeed, 2019's largest deal was a C\$885 million (\$680 million) buy-in transaction pursuant to which Stelco Inc. transferred pension liabilities in respect of 2,725 retirees and beneficiaries to The Canada Life Assurance Co., Sun Life Assurance Co. of Canada, BMO Life Assurance Co. and

the Co-operators Life Insurance Co. This deal surpasses the largest Canadian deal of 2018, namely the transfer of C\$750 million (\$552 million) in pension liabilities by Alcoa.

Both 2019 transactions highlight the trend in Canada to split deals among two or more insurers. This practice helps insurers to limit their overall exposure and to offer better pricing, but has also limited the need for reinsurance (which, by way of comparison, has come to play an integral role in the U.K. market). Recent developments in the Canadian market suggest that this may soon change as three longevity-only reinsurance transactions were announced in a space of a few months in 2019. Each of the transactions was undertaken by The Manufacturers Life Insurance Company. In February and March 2019, it announced that it had entered into longevity reinsurance transactions with RGA Life Reinsurance Company of Canada and Bermuda-based PartnerRe covering 45,000 and 25,000 in-force annuitants, respectively. The longevity risk for a further 5,000 annuitants was reinsured with PartnerRe in May. Also noteworthy was Legal & General's C\$200 million (\$153 million) reinsurance transaction with Brookfield Annuity Company. The transaction is the first in an arrangement under which Legal & General will reinsure a share of the buy-in annuities greater than C\$100 million written by Brookfield.

C. Looking Forward to 2020

At the end of 2019, all indications suggest that the U.K. and North America markets will continue to expand in 2020. In the U.K., 2019's record-breaking bulk annuities market should have a knock-on effect for reinsurers in 2020 such that we expect to see individual deal size and overall deal volume increase in the U.K. longevity market and, in turn, to facilitate the expansion of third-party capital and additional funded reinsurance transactions. High interest among plan sponsors and the pressure of ever-increasing PBGC premiums should continue to push U.S. plans to derisk. We expect to see the current trend toward small and midsize deals continue, but not to the exclusion of higher-profile jumbo deals, and if interest rates remain low, we also may see more frequent use of the debt markets to fund pension contributions and pension risk transfers. In Canada,

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regulatory changes introduced in 2017 and 2018, together with well-funded plans, a broad pool of insurers and the penchant for shared deals, have created the potential for

transaction size and volume to continue to grow and we expect it do so in 2020.

VI. CAPITAL MARKETS ACTIVITY

A. U.S. Capital Markets Activity

i. Initial Public Offerings

Following 2018, in which AXA Equitable Holdings, Inc. logged the second-largest IPO of the year, 2019 was a subdued year for insurance company IPOs. In July Swiss Re suspended its previously scheduled U.K. IPO of ReAssure Group plc, citing heightened caution and weaker underlying demand in the U.K. primary market from large institutional investors. However, in the biggest deal in the European insurance industry last year and valuing ReAssure at the top of the range previously sought from the London market, Swiss Re ultimately agreed to sell ReAssure to Phoenix Group Holdings plc in December for \$4.3 billion, consisting of a mix of cash and Phoenix shares.

Palomar Holdings Inc., ProSight Global Inc. and BRG Group Inc. made their U.S. market debuts. Palomar has performed particularly well; at the time of writing the stock price has more than doubled since the IPO in April, valuing the company at more than \$1.1 billion. Palomar is backed by Genstar Capital and focuses on providing specialty property insurance to both individuals and businesses in what it views as underserved markets, such as the markets for earthquake, wind and flood insurance.

Following investor pushback on IPO valuations in 2019, a backlog of companies are looking to go public in 2020, which, along with the election at the end of the year, could result in a challenging environment for those companies that elect to debut; we await to see whether any insurance companies will be among those taking the plunge.

ii. Rating Agency Hybrid Capital Criteria

Hybrid securities are securities that combine elements of equity securities and debt securities. They generally provide a fixed or floating rate of return, like a debt security, but include certain equity-like features which may reduce the certainty as to the timing and amount of any such payments, or subordinate the holder to other creditors in

the event of an insolvency. An insurance company issuer may benefit from treating the hybrid security as debt for tax purposes, but a rating agency may treat a portion of the outstanding amount of the hybrid security as equity depending on its features.

Some public insurance companies have consistently issued various types of hybrid securities, but given the trend over the last few years to issue preferred stock, as opposed to junior subordinated debentures (e.g., Allstate, MetLife, AIG, Equitable, Athene, Voya and Brighthouse), we thought it would be useful to summarize the most recent Moody's and S&P hybrid capital criteria.

a. Moody's

Moody's assigns equity credit based on a basket spectrum from "A" to "E," with basket "E" receiving 100% equity credit (e.g., common stock) and basket "A" receiving zero equity credit (e.g., senior notes). Moody's assesses the amount of equity credit to assign hybrid securities issued by investment-grade issuers, like insurance companies, by asking three questions:

- (1) Does the hybrid security absorb losses or provide financial protection for a going concern?

Generally, Moody's would assign greater credit to a hybrid security that would provide flexibility to an issuer before a default, e.g., the issuer may skip payments on a non-cumulative basis on the hybrid security in order to avoid an interest payment default on senior notes.

- (2) Does the hybrid security absorb losses for a gone concern?

Less equity credit would be assigned to a hybrid security which would allow the issuer to skip a cash payment, but accumulate such payments for payment at a later date, or cover the payment with the proceeds of sales of more equity-like securities (an alternative coupon settlement mechanism or ACSM).

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- (3) Will the loss-absorbing hybrid security be there when the issuer needs it?

Moody's will look at the potential timing of the hybrid security's redemption or repayment, the features of any replacement security and the expected changes to the issuer's capital structure over time.

Moody's may assign up to 25% equity credit (basket "B") for subordinated debt securities, provided that the hybrid security has a maturity of at least 30 years and the issuer has the option to skip coupon payments. If the issuer can only defer coupon payments in the event the issuer falls below certain minimum regulatory capital ratios (a minimum capital trigger) or after it suspends payments on junior or parity securities for more than six months (a dividend pusher), the hybrid security would be required to have a maturity in excess of 60 years in order to receive basket "B" treatment.

For preferred stock Moody's generally assigns 50% equity credit (basket "C") because these hybrid securities almost always have no maturity. Hybrid securities can still receive basket "C" treatment if the issuer is able to defer or completely skip coupon payments, but if coupon payments can only be skipped in the event the issuer falls below a minimum capital trigger, the coupon payments must be non-cumulative.

Generally, hybrid securities lose all equity credit 10 years before their maturity, but a strong incentive for an issuer to redeem the hybrid could mean equity credit is reduced even before then, e.g., an increase in the coupon prior to 10 years after the hybrid security is issued or a coupon step-up greater than 100 basis points over the initial credit spread would result in a reduction of equity credit.

b. S&P

S&P assigns "high," "intermediate" or "no" equity content to hybrid securities based on S&P's view as to the degree to which the security has equity-like features. S&P analyzes a hybrid security for (i) its ability to absorb losses or conserve

cash, if and when needed, and (ii) its availability to absorb losses or conserve cash, based on the hybrid instrument or its replacement remaining outstanding for a sufficiently long period. Furthermore, S&P will look to both the features of the hybrid security and the intent of the issuer to it or its replacement remaining outstanding for a sufficiently long period of time.

S&P generally only assigns "high" equity content to mandatorily convertible securities, so most hybrid securities are structured to meet S&P's "intermediate" content requirements, which require the security to:

- be available and able to absorb losses or conserve cash in stress scenarios, before the point of bankruptcy;
- have at least 20 years until the effective maturity if the issuer's credit rating is at BBB- or higher, but for prudentially regulated insurance companies, the hybrid security may only have at least 10 years until the effective maturity;
- be subordinated in liquidation to all senior debt of the issuer;
- not be redeemable within five years of the issue date (unless the call option is based on an external event (e.g., a "tax event," a "rating agency event" or a "regulatory capital event"));
- be able to absorb losses or conserve cash, by skipping or deferring coupon payments for at least five years without triggering a default; and
- be free from features that discourage or materially delay deferral, such as a higher rate on accrued deferred amounts, or dividend pusher restrictions of more than one year, or an ACSM that does not incorporate adequate antidilution features. Coupon payments can be either cumulative or noncumulative.

The S&P "intermediate" equity content criteria are similar in substance to the requirements for Moody's basket "B" or "C" treatment and this combination is the "sweet spot" that we expect most insurance company issuers will continue to target.

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iii. SEC Comment Letters

In 2019 the SEC Staff (the “Staff”) generally concentrated its comment letter focus on the same topics that have been under the spotlight in recent years.

In our view, disclosures concerning non-GAAP financial measures, internal and disclosure controls and procedures, short-duration contracts/loss reserves, revenue recognition and reinsurance continued to receive, and will continue to receive, the majority of comments for insurance companies and, since the first three of those topics attract the bulk of the Staff’s comments, we have discussed them further below.

a. Non-GAAP Financial Measures

Following the May 2016 publication of the Staff’s additional C&DIs on Non-GAAP financial measures, the Staff has consistently commented on individually tailored accounting principles and the equal or greater prominence of the comparable GAAP financial measure. In some instances the Staff has questioned certain of the adjustments used to calculate the non-GAAP financial measure in the context of the issuer’s explanation as to why the non-GAAP measure is useful to investors and management, i.e., a coherent reason must exist linking each adjustment to the ultimate use of the non-GAAP financial measure.

b. Internal and Disclosure Controls

The Staff’s drive here seems to be identifying material weaknesses in controls in a timely manner, i.e., not only when a control deficiency results in an accounting error. The issuer’s evaluation and conclusion about the severity of a control deficiency should include a forward-looking analysis as to the likelihood and magnitude of any such error occurring and not being prevented or detected by the controls in place. The Staff is especially questioning instances in which management attributes a material accounting error to a control deficiency, but fails to conclude that such deficiency is a material weakness in internal controls. Out-of-period errors corrected during the

current period may also draw comment if the prior period amounts are not also revised.

c. Short-Duration Contracts/Loss Reserves

Since these disclosures require significant judgment on the part of management, it is unsurprising to see that they attracted additional Staff comment. New information or changes to experience in a period often drew a comment from the Staff on the reasons why this information/experience was not available in prior periods, and in some instances, why such an adverse development in the period did not amount to the correction of an error. The amount and appropriateness of aggregation of information was also questioned by the Staff, especially to the extent information was aggregated across segments or products.

B. European and U.K. Capital Markets Activity

Regulation (EU) 2017/1129 (the “Prospectus Regulation”) came into force in full on July 21, 2019 and repealed and replaced the Prospectus Directive (2003/71/EC) and the Prospectus Regulation (809/2004). All of the provisions of the Prospectus Regulation are already in force, expanding the exemptions available from the requirement to publish an approved prospectus in Europe. For example, the exemption from the requirement to publish a prospectus for issuances of a class of securities already admitted to trading on a regulated market has been increased from up to 10% to up to 20% over a 12-month period of the class of securities already admitted to trading.

An important new provision of the Prospectus Regulation provides E.U. member states with the discretion to exempt from the requirement to publish an approved prospectus public offers of securities with a total consideration in the E.U., calculated over a period of 12 months, of between €1 million and €8 million. The previous threshold was €5 million, calculated over a period of 12 months. The U.K. has set its threshold at €8 million. Notwithstanding this increase, we note that other E.U. member states could set a lower discretionary threshold than the U.K. Accordingly, issuers engaging in cross-border offerings will need to first check the corresponding discretionary threshold in each

VI. Capital Markets Activity

relevant E.U. member state into which they propose to market the offering.

Why the Prospectus Regulation? Market participants increasingly were calling for reform of the European prospectus regime to make it more accessible for small and midsize enterprises seeking to raise capital. The European Commission identified the reform of the current European prospectus regime as a priority as part of its Capital Markets Union initiative intended to strengthen E.U. capital markets.

Another key change as a result of the Prospectus Regulation is the introduction of a new universal registration document regime (similar to the U.S. shelf registration scheme). The new regime should benefit frequent issuers, who will be able to gain faster access to the capital markets. Where a competent regulatory authority has approved an issuer's universal registration document for two consecutive years, future universal registration documents may be filed or amended without prior approval. Any prospectus published using a universal registration document will also benefit from a five-working-day approval process (currently 10 working days for other prospectuses). Additionally, issuers may use their universal registration document to satisfy their obligation to publish annual financial reports and half-yearly reports. Frequent issuers will appreciate the ability to consolidate their public filings, saving the time and expense currently required to replicate such information.

In addition, in other streamlining of disclosures, the Prospectus Regulation has introduced a new "prospectus lite" regime, which will be available for follow-on issuances by issuers with existing securities admitted to trading on a regulated market continuously for the previous 18-month period.

One of the more controversial amendments to the previous regime introduced by the Prospectus Regulation is the revisions to the risk factors. The Prospectus Regulation's Article 16 requires risk factors in the prospectus to be categorized by their nature and presented in order of their materiality. Additionally, to the extent possible, the issuers must quantify the risks presented. This requirement has

caused significant uneasiness among market participants who believe that quantifying certain risks might lead to having to make statements, in the worst case scenario, that could imply the insolvency of the company—for example when disclosing the risk of unlimited regulatory fines—although the prospects of an unlimited fine may be remote, the company would, under the new rules, be required to state the quantifiable effects of such scenarios. The European Securities and Markets Authority published a report and guidelines to assist national competent authorities in their review of the specificity and materiality of risk factors. However, little guidance has been provided on the subject of quantifying risks. It remains to be seen how the market participants will respond to this requirement and how the regulators will enforce it.

C. Non-U.S. Regulatory Capital Issuances

The issuance of preference shares or subordinated notes by insurance groups, intended to qualify as Tier 2 capital under Solvency II, continued to be an important part of capital-raising transactions in 2019. Regulatory capital for insurance groups under Solvency II is divided into three tiers based on both permanence and loss absorbency (Tier 1 being the highest quality). Tier 1 capital tends to include ordinary share capital, non-cumulative preference shares and relevant subordinated liabilities. Instruments that do not meet the Tier 1 requirements on permanence or loss absorbency may still be categorized as Tier 2 or Tier 3 items. Tier 2 capital is likely to include cumulative preference shares and subordinated liabilities with a shorter duration. In 2019, issuances by insurance groups tended to be structured flexibly in such a way as to qualify as Tier 2 capital under Solvency II or under other applicable supervisory regulations (notably the Bermuda Monetary Authority rules) in the event that the group becomes regulated in another regulatory jurisdiction.

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VII. PRINCIPAL REGULATORY DEVELOPMENTS AFFECTING INSURANCE COMPANIES

A. United States Regulatory Developments

At the 2019 Spring National Meeting of the NAIC, NAIC President and Maine Insurance Superintendent, Eric A. Cioppa, highlighted the NAIC's 2019 regulatory priorities: (1) enhancing regulators' assessment of the financial strength of insurers with the continued development of a group capital calculation tool; (2) fostering stable financial markets by analyzing the impact of broader financial markets and economies through the Macro-Prudential Initiative; (3) protecting the industry from the rising incidence of cyberattacks; (4) promoting a higher standard of care in the sale of annuity products by amending the Suitability in Annuity Transactions Model Regulation; (5) ensuring that policyholders receive the benefits of their long-term care insurance policies when they need them, by reviewing the solvency position of long-term care insurers; (6) engaging globally, both through standard-setting organizations and through regional and bilateral engagement; (7) improving health insurance market stability; and (8) continuing to address climate-related risk by creating incentives for resiliency.

As summarized below, during 2019 the NAIC addressed most of these priorities and more, with work left to be done during 2020.

i. Group Capital

Since 2013, the International Association of Insurance Supervisors ("IAIS"), a membership organization of international insurance supervisors and regulators, has been working on a group capital standard (i.e., the "insurance capital standard," or "ICS"), that will be applicable to internationally active insurance groups ("IAIGs"). The IAIS's approach to the calculation of group capital has been rejected by U.S. insurance regulators and federal authorities for various reasons, including its

emphasis on Europe's approach to insurance regulation, non-recognition of certain instruments, such as surplus notes, used to finance U.S. insurance operations and reliance on market-adjusted capital. As a result, the NAIC has been developing its own group capital calculation based on an aggregation methodology (the "GCC"), which is intended to be a regulatory "tool," as opposed to a capital requirement. The GCC is based on an analysis of available capital/financial resources and required regulatory capital for group members. The GCC builds on the calculation of risk-based capital for U.S. insurance companies.

International standards adopted by the IAIS—including the ICS—are non-binding in the United States. However, substantial risk exists that the ICS will be imposed on U.S. insurance groups with operations abroad by virtue of its being adopted as a prudential capital requirement ("PCR") outside the United States. This risk will be eliminated if the IAIS determines that the GCC produces "comparable outcomes" to the ICS—in which case a U.S. insurance group that will be subject to the GCC in its home U.S. jurisdiction will also not be required to comply separately with the IAIS's group capital requirements (i.e., the ICS).

The good news is that the ICS is not expected to be implemented as a PCR in any non-U.S. jurisdiction until 2025 at the earliest, since the current version of the ICS (i.e., ICS Version 2.0), which was adopted by the IAIS in November of last year, will be subject to a monitoring period until that time, during which the ICS will not be a PCR. The bad news is that the IAIS does not expect to make a decision on whether "aggregation" group capital methodologies such as the GCC produce "comparable outcomes" to the ICS until the third quarter of 2024. Faced with the prospect that the IAIS would make this decision unilaterally, at its own discretion, and, potentially, mere months before adoption of the ICS as a PCR in some non-U.S. jurisdictions, U.S. insurance regulators and federal authorities spent much of last year lobbying the IAIS to define the parameters of its decision-making process regarding comparability more clearly. These efforts culminated in a victory for the U.S. insurance industry in November of last year, as the IAIS released an Explanatory Note that: (i) defined "comparable outcomes" to the ICS to include an "Aggregation Method"

VII. Principal Regulatory Developments Affecting Insurance Companies

that would produce similar, but not necessarily identical, results over time that trigger supervisory action on group capital adequacy grounds, and (ii) set forth an approach for developing criteria to determine whether an “Aggregation Method” produces “comparable outcomes.” Because the GCC is based on an “Aggregation Method,” the Explanatory Note was applauded by the NAIC as “providing a clear path” for U.S. group capital calculations to be considered “comparable” to the ICS.

We note that the Covered Agreements discussed in Section VII.D. of this report provide that the E.U. and the United Kingdom may not impose their group capital requirements on a U.S. insurance group with operations in the E.U. or the United Kingdom, respectively, if such U.S. insurance group is subject to a group capital requirement meeting certain criteria in its home U.S. jurisdiction. If the GCC meets these criteria, the Covered Agreements should shield U.S. insurance groups with international operations that are confined solely to the E.U. and the United Kingdom from the applicability of international group capital standards (such as the ICS) to their operations.

Meanwhile, in the U.S., the NAIC’s work on developing the GCC proceeded as scheduled during the past year. Field testing of the GCC was successfully completed last fall, and the NAIC’s Group Capital Calculation (E) Working Group now plans to make revisions to the GCC template and instructions with the goal of adopting the GCC later this year. However, adoption of the GCC by the states may take longer, since the NAIC has determined that certain amendments to its model laws will be required in order to authorize U.S. insurance regulators to require filings of the GCC and provide for confidential treatment for these filings. The NAIC will need some time to draft and adopt these amendments, at which point state legislatures will need to consider these amendments and enact them—a process that is also likely to take a considerable amount of time.

ii. Systemic Risk

Following the 2008 financial crisis, the U.S. Financial Stability Oversight Council (“FSOC”) designated several

U.S. insurance groups as systemically important financial institutions (“SIFIs”) for supervision by the Federal Reserve. This so-called “entity-based” approach to systemic risk (i.e., the approach of subjecting a specific insurance group to enhanced supervision because its activities could pose a threat to U.S. financial stability) has become disfavored in recent years. Between 2017 and 2018, all insurance groups that had previously been designated as SIFIs by the FSOC had these designations rescinded. In addition, both federal authorities and state insurance regulators have moved away from the “entity-based” approach to systemic risk to an “activities-based approach” (“ABA”) that focuses on potential systemic industry activities in the insurance sector as a whole.

As part of this coordinated move towards the ABA, the NAIC has engaged in a Macro-Prudential Initiative (“MPI”), which is intended to assist U.S. insurance regulators in identifying various risk-exposures of the U.S. insurance sector. One key component of MPI is the development of a liquidity stress-test framework, which the NAIC intends to use as a regulatory tool, and which will apply to certain large U.S. life insurers and insurance groups. The proposal for the liquidity stress test framework is expected to be finalized within the next few months and will test liquidity under various stress scenarios, including an interest rate spike, a decline in equity markets and a decline in credit spreads. It is expected that large life insurers will submit year-end 2019 data under the proposed framework to their lead state regulators in the third quarter of this year.

In addition, in December 2019, the FSOC released final interpretive guidance for designating non-bank SIFIs that incorporates an ABA, and that provides that the FSOC will pursue entity-specific determinations only if a potential risk or threat cannot be addressed through an ABA. This final guidance, which was praised by the NAIC, becomes effective on January 29, 2020.

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iii. Innovation and Technology

a. Amendments to Model Law Prohibiting Unlawful Rebates and Inducements

The insurtech industry has long clamored for revisions to state insurance laws prohibiting unlawful rebates and inducements in light of new technologies being deployed to add value to existing insurance products and services. These new technologies include, for example, devices that can help mitigate risk or loss (e.g., home monitoring devices, fitness bands or activity trackers). While some states have enacted laws clarifying that unlawful rebates and inducements do not include services or other offerings that relate to loss control of the risks covered under an insurance policy, the insurtech industry is effectively prevented from offering such services or other offerings on a nationwide basis until these laws are adopted in every U.S. state.

In response to these concerns, in 2019, the NAIC's Executive (EX) Committee approved a model law development request to draft amendments to the NAIC Unfair Trade Practices Act to clarify what is considered a "rebate" or "inducement" in light of innovative insurance technologies. Work on amendments to this model law is expected to commence later this year. We note that any model law amendments adopted by the NAIC will need to become an accreditation standard in order to truly ensure uniformity of any applicable exemptions from antirebating laws across the states.

b. Sandboxes

Last year, certain states took action to establish regulatory "sandboxes"—i.e., legislative or regulatory schemes pursuant to which an insurtech innovator could test a new product or technology in a contained environment without having to comply with certain insurance laws of the relevant state. Similar sandboxes for Insurtech products and technologies had previously been created in certain international jurisdictions.

In March 2019, Kentucky became the first U.S. jurisdiction to enact a comprehensive statutory scheme pursuant

to which an innovative product, process, method or procedure in the field of insurance may be submitted to the Kentucky insurance regulator for admission in the state's insurance sandbox. If approved, the product, process, method or procedure could be "beta-tested" in Kentucky, and the Kentucky insurance regulator would not take any administrative or regulatory action with respect thereto for the duration of this "beta test." In addition, Vermont adopted the regulatory sandbox concept last year by enacting a statute permitting the Vermont insurance regulator to waive specific requirements of Vermont insurance laws for a specified time period with respect to a new, innovative or more efficient insurance product, service or technology if certain requirements are met. Going forward, we expect that the number of states that have regulatory sandboxes available to the Insurtech industry will continue to increase.

c. Accelerated Underwriting in Life Insurance

Last year saw increased focus by U.S. state insurance regulators on programs used by some life insurers that allow applicants to forgo medical examinations if they meet certain predetermined thresholds based on the life insurer's analysis of data sources other than the applicant's medical history—such as prescription histories, motor vehicle records, consumer data, and credit scores. These practices may significantly reduce the underwriting decision time for certain applicants, and have therefore been colloquially referred to in the industry as "accelerated underwriting" practices.

In January 2019, the New York State Department of Financial Services issued a circular letter that relates to use by life insurers of data or information sources that are not directly related to the medical condition of the applicant (with certain exclusions), for certain types of underwriting or rating purposes—including as a proxy for traditional medical underwriting. The circular letter generally prohibits life insurers from using such data or information, including algorithms or predictive models, in this fashion unless: (i) the insurer can establish that the data source does not use and is not based in any way on prohibited criteria, such as race, color, creed, etc.; and (ii) this use is not unfairly discriminatory and otherwise complies with the

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requirements of the New York insurance laws. In addition, the circular letter requires insurers using such data or information, including predictive models, to make certain additional disclosures to consumers.

In addition, in August 2019, the NAIC established the new Accelerated Underwriting (A) Working Group to consider the use of external data and data analytics in accelerated life insurance underwriting. The Working Group expects to determine its targeted work product (e.g., a white paper, model bulletin or model law) in 2020.

d. Big Data

Big data refers to large, diverse sets of information that grow at ever-increasing rates. The data can come from many sources, such as comments on social networks and websites, personal electronics and applications, and product purchases, among other sources. The NAIC's Big Data (EX) Working Group spent much of last year gathering information on the use of big data in fraud detection and claim settlement, with the goal of assessing whether current regulatory frameworks used to oversee this area should be modified. Certain insurance regulators hold the view that big data vendors used by insurers are "black boxes" into which regulators have little visibility, and that existing regulatory tools are inadequate to ensure that consumers are protected when insurers use data supplied by these vendors. We expect that this topic will receive further attention at the NAIC and/or at the state level this year.

e. Artificial Intelligence

In August 2019, the NAIC established a new Artificial Intelligence (EX) Working Group to study the use of artificial intelligence ("AI") in the insurance sector and develop related regulatory guidance and recommendations, including "guiding principles" for use of AI in the insurance sector. The Working Group has released its initial draft of these "guiding principles" for comment by interested parties, and will continue its work in 2020.

f. Data Privacy

In October 2019, the NAIC established a new Privacy Protections (D) Working Group to review state insurance privacy protections regarding the collection, use and disclosure of information gathered in connection with insurance transactions. This initiative comes on the heels of the enactment of the California Consumer Privacy Act (which is a non-industry-specific privacy law that creates new consumer rights relating to personal information that is collected by businesses) and consideration of data privacy laws by legislatures in numerous other U.S. states. If needed, the new Working Group will recommend changes to existing NAIC model laws and regulations relating to data privacy.

g. Data Security

The NAIC previously developed a Data Security Model Law, which requires insurance licensees to maintain an information security program, investigate cybersecurity events and notify state insurance regulators of such events. Only eight states had adopted this model law as of December 2019, and the NAIC continues to urge the remaining states to adopt it soon in order to avoid the possibility of federal legislation governing insurer data security that would preempt state insurance laws.

iv. Annuity Suitability

In December 2019, the NAIC's Life Insurance and Annuities (A) Committee adopted revisions to the Suitability in Annuity Transactions Model Regulation (as amended, the "Suitability Model Regulation"), which generally require that recommendations of annuity products to consumers comply with a "best interest" standard. As background, last spring, the Securities Exchange Commission ("SEC") adopted its final Regulation Best Interest, which sets forth what the SEC calls a "best interest" standard for sales of securities by broker-dealers. As a result of this action by the SEC, the NAIC felt compelled to also incorporate the concept of "best interest" into the Suitability Model Regulation, rather than a previously considered fiduciary standard, which would have been a higher standard.

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Specifically, the Suitability Model Regulation: (i) requires an insurance producer, when making a recommendation of an annuity, to act in the “best interest” of the consumer under the circumstances known at the time the recommendation is made, without placing the producer’s or the insurer’s financial interest ahead of the consumer’s interest, and (ii) provides that an insurance producer has acted in the best interest of the consumer if the producer has satisfied obligations regarding care, disclosure, conflict of interest and documentation that are set forth in the Suitability Model Regulation. The Suitability Model Regulation must now be adopted by the Executive (EX) Committee, which we expect to occur in or around February 2020.

v. Long-Term Care Insurance

Solvency and stability in the long-term care (“LTC”) insurance market continues to be a key priority for the NAIC. In 2018, an executive-level task force was formed by the NAIC to focus on coordination and consistency in LTC products. This task force has now subdivided its efforts into six work streams: evaluation of state LTC rate review practices; LTC restructuring techniques; reduced benefit options offered to consumers; reserve valuation issues; states’ use of non-actuarial factors in rate review; and identifying additional data needs of the task force. It is expected that the task force will deliver a proposal on these LTC-related matters to the Executive (EX) Committee by November 2020.

B. U.S. Insurance Business Transfer and Division Laws

i. Background

In recent years, several U.S. states have enacted insurance business transfer legislation or promulgated regulations meant to approximate the effect of Part VII of the U.K. Financial Services and Markets Act 2000, which allows an insurer to transfer its business, or a book of business, to another entity through a regulatory and judicial approval process, generally without the need for individual policyholder consent (a “Transfer Law”). Separately, a few other U.S. states have enacted new corporate reorganization laws allowing an insurer to divide into separate companies

(a “Division Law”). The division, more like the reverse of a merger, applies to insurance companies on a corporate level and is not limited to classes of business or runoff blocks.

Transfer Laws and Division Laws may provide an attractive alternative to the reinsurance structures currently used to transfer blocks of business from one insurer to another by providing more legal finality. For example, in an indemnity reinsurance transaction, the reinsurer assumes the obligation to pay the benefits under the reinsured policies when they become due. If the reinsurer is unable to satisfy its obligations, the ceding insurer remains residually liable. An insurance business transfer brings the transferor complete finality for the transferred policies while ensuring that policyholders are adequately protected. A division also provides legal finality since the blocks of business allocated to a newly created company in the division will no longer be the responsibility of the dividing company.

The year 2019 saw an acceleration of activity related to Division Laws, with the passage of Division Laws in Iowa and Georgia that closely follow the Connecticut model. As described below, amid interest and questions from the industry, the National Association of Insurance Commissioners (“NAIC”) and others, including the American Council of Life Insurers (“ACLI”) and the National Council of Insurance Legislators (“NCOIL”) have been carefully studying these laws and considering their potential implications throughout 2019.

ii. Division vs. Transfer Laws

Transfer Laws and Division Laws are new tools in the United States for insurers to manage blocks of insurance business, to transfer business in the case of Transfer Laws or to create more transformative corporate reorganizations in the case of Division Laws. Although often mentioned in the same sentence, Transfer Laws and Division Laws are distinctly different.

Transfer Laws allow an insurer to transfer legal liability of some or all insurance policies and reinsurance agreements to another insurer domiciled in a state with a Transfer Law.

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This restructuring can be within a group or to a third party by regulator- or court-ordered novation, which terminates the transferor's rights, obligations and liabilities under the transferred policies or reinsurance agreements, which may include extra-contractual obligations. The scope of the Transfer Laws varies in each state with respect to the types of business that may be transferred, approval requirements from state insurance regulators or courts, and policyholder objection or "opt out" rights. For example, Oklahoma's Insurance Business Transfer Act (the "Oklahoma Transfer Act") applies to both active and runoff books of business for all lines of insurance. Vermont's Transfer Law, however, only applies to closed blocks of commercial non-admitted insurance policies or reinsurance agreements.

Division Laws, on the other hand, result in a corporate-level reorganization, similar to a merger. Under a Division Law, an insurance company domiciled in a state with a Division Law divides itself into two or more resulting companies through a plan of division that allocates assets and liabilities between the resulting companies, and the division, like a merger, is effected by operation of law. Following a division, each resulting company is responsible individually for (i) the policies and liabilities that the resulting company issues or incurs after the division; and (ii) the policies and liabilities of the dividing company that are allocated to the resulting company by the plan of division. If the dividing company survives the division, it only remains responsible for the policies and liabilities that are not allocated to the new company by the plan of division. The Division Laws also do not provide for individual policyholder consent since a division is a corporate-level transaction similar to a merger. The insurance regulator of the dividing insurer's domiciliary state will be charged with ensuring that the interests of policyholders and other interest holders (e.g., shareholders) are adequately protected and that liabilities allocated by the division are adequately supported by assets of the resulting insurers.

iii. Current Developments

As of the date of this report, Transfer Laws have been enacted in Oklahoma, Rhode Island and Vermont, and Division Laws have been passed in Connecticut, Illinois,

Michigan, Iowa and Georgia. Currently, similar legislation has also been introduced in Nebraska.¹

Although we are not aware of any transactions that have been completed under the Division Laws or the Transfer Laws,² the Oklahoma Insurance Commissioner has approved the first transfer plan under the Oklahoma Transfer Act for the transfer of the insurance and reinsurance business of Providence Washington Insurance Co., a Rhode Island insurer ("Providence"), to Yosemite Insurance Co., an Oklahoma insurer ("Yosemite"). Pursuant to the Oklahoma Transfer Act, the transfer plan will now need to be submitted to the District Court of Oklahoma County for a hearing and final approval. Upon the court's approval of the transfer plan, Yosemite will become directly liable to the policyholders of Providence and Providence's obligations under the transferred policies would be extinguished. Both insurers are subsidiaries of Enstar Group Limited. We have also been informed by the insurance departments of several states that companies are in discussions with the departments with the goal of ultimately filing division or transfer plans.

The NAIC formed two new working groups in 2019 to consider issues related to Division Laws and Transfer Laws and draft a white paper for regulators. Over the past several months, the NAIC's Restructuring Mechanisms Working Group has received presentations from regulators in states with Division Laws and interested parties to assist in the development of the white paper with best practices. The white paper is expected to be completed by August 2020. It is possible that many companies interested in using these laws will wait until the NAIC white paper is released.³ In addition, NCOIL proposed an Insurance Business Transfer Model Act in 2019 based on the Oklahoma Transfer Act. ACLI also developed principles and guidelines with respect to these laws in 2019.

¹ Nebraska Legislative Bill 602.

² In 1996, CIGNA effected a division of an insurance subsidiary to isolate asbestos liabilities in a newly formed subsidiary, although such division was effected pursuant to Pennsylvania's general business corporations division law.

³ Certain regulators have also noted at discussions of the NAIC's Restructuring Mechanisms Working Group that they do not plan on promulgating regulations for the Division or Transfer Laws until the NAIC white paper is complete.

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iv. Review by Regulators

Because Transfer and Division Laws are relatively new developments, the standards that regulators will apply and the types of evidence that will be required are still under development. Certain specific standards for approval are set forth in the Transfer and Division Laws. Also, best practices have been developed by ACLI and are being developed by the NAIC that may be useful to regulators and insurers seeking approval of a transfer or division.

The Transfer and Division Laws require that a company seeking to effectuate a transfer or division must file a Plan with the relevant state insurance regulator, demonstrate that the Plan meets the applicable regulatory or statutory standards and obtain regulatory approval. Under the Transfer Laws, the Plan must be filed with the assuming insurer's domiciliary insurance regulator. Under the Division Laws, the Plan must be filed with the dividing company's domiciliary insurance regulator.

With respect to the Transfer Laws, a Plan should include a description of the policies and reinsurance agreements to be transferred, financial information or opinions demonstrating that the proposed transfer will meet the applicable standards, including, for example, that the assuming company will have sufficient assets to meet its liabilities after the transfer, and evidence that the transfer has been approved or not objected to by the transferring company's domiciliary regulator. The Transfer Laws prescribe detailed standards for the assuming insurer's insurance regulator and/or court's approval of a Plan. In Rhode Island and Oklahoma, the Transfer Plan must be approved by a court after it has been approved by the relevant state insurance regulator. The court's approval of a Plan requires a finding that the Plan will have no material adverse impact on policyholders (similar to the test for Part VII Transfers in the U.K.). In Vermont, although no court approval is required, the regulator will make several findings, including a finding that the Plan will have no material adverse impact and a finding regarding the solvency of the assuming company.

In a division, the Plan will set out a detailed allocation of assets and liabilities among the resulting insurers. Connecticut and Illinois allow, and Michigan, Iowa and Georgia require, the insurance regulator to hold a public hearing on the Plan before issuing an approval. The regulator must be satisfied that several standards have been met, including that interests of policyholders and other stakeholders are adequately protected and the resulting companies will have adequate assets. The existing Division Laws do not provide a court approval process for a division.

C. Other International Developments Affecting U.S. Insurance Regulation

i. IAIS

Following years of development, the IAIS adopted a comprehensive set of reforms related to the cross-border supervision of IAIGs in November 2019. The adopted reforms include the Common Framework for the Supervision of IAIGs ("ComFrame"), which establishes supervisory standards and guidance focused on the group-wide supervision of IAIGs. ComFrame has now moved into its implementation phase, with the IAIS focusing on supporting its members' implementation efforts. The NAIC will now commence the process of reviewing ComFrame in order to determine whether any regulatory gaps exist between ComFrame and the existing U.S. insurance holding company regulatory system.

Also in November 2019, the IAIS adopted the Holistic Framework for Systemic Risk in the Insurance Sector (the "Framework"), which replaced the previous "entity-based" approach to systemic risk with a holistic approach that: (i) includes an ABA that focuses on potential systemic industry activities in the insurance sector, and (ii) retains elements of the previous entity-based approach in recognizing that systemic risk may arise from activities by a single large insurance company or group. Implementation of the Framework will now commence, including implementation of elements thereof by regulatory bodies and a global monitoring exercise that is designed to track global market trends and detect the build-up of systemic risk in the global insurance sector. In connection with the implementation of the Framework, the Financial Stability

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Board, a nonprofit international body (“FSB”) has suspended its process of identifying global systemically important insurers (“G-SIIs”) until November 2022, at which point the FSB will make a final decision as to whether the G-SII designation system should be discontinued permanently.

ii. IMF

The International Monetary Fund (the “IMF”) is currently conducting the Financial Sector Assessment Program (“FSAP”) of the United States, which is conducted every five years, and which analyzes the strength and scope of the U.S. insurance regulatory scheme under the standards of the Insurance Core Principles (ICPs) promulgated by the IAIS. It is expected that the IMF will publish a technical note with its findings from the FSAP in or around the summer of 2020. The IMF’s findings will be closely watched by the U.S. insurance industry, since any regulatory gaps identified during the FSAP could result in the development of new regulatory requirements by the NAIC.

D. Changes to U.S. Regulation Shaped by the Covered Agreement

The U.S./EU Covered Agreement, scheduled to become effective in September 2022, drove the NAIC to adopt substantial changes to its model laws that will result in a new U.S. regulatory framework for reinsurance collateral. This new framework will apply not only to E.U.-domiciled reinsurers but also to U.S. reinsurers and even certain non-U.S. reinsurers whose domestic jurisdictions have not signed a covered agreement with the U.S. The U.S./EU Covered Agreement is also the catalyst for changes to NAIC model laws regarding the regulatory supervision of global insurance groups (including solvency, governance, capital and reporting). Potential federal preemption of state insurance laws that are inconsistent with the U.S./EU Covered Agreement has motivated these expedited and comprehensive anticipated changes to state regulation.

i. Covered Agreement Required Changes to NAIC Reinsurance Models

a. Substantive Provisions

On June 25, 2019, the NAIC amended the NAIC Credit for Reinsurance Model Law and Regulation consistent with the requirements of the bilateral agreement on insurance and reinsurance entered into by the U.S. and the E.U. (the “Covered Agreement”).⁴ From a U.S. perspective, the Covered Agreement eliminates the need for an Eligible Reinsurer domiciled in the E.U. to post reinsurance collateral with respect to obligations assumed from U.S. cedents. An Eligible Reinsurer must satisfy specific conditions related to minimum capital and surplus (\$250 million) and ongoing solvency ratios. In addition, an Eligible Reinsurer must agree to submit to the jurisdiction of U.S. courts, comply with U.S. judgments obtained by its U.S. cedents and confirm that it is not participating in a solvent scheme of arrangement. In order to facilitate multistate recognition of Eligible Reinsurers, a state insurance commissioner may, in her discretion, defer to the determination of another state in a “passporting” process. States are required to maintain a list of Eligible Reinsurers.

No collateral will be required of E.U. Eligible Reinsurers for reinsurance agreements entered into, amended or renewed after the effective date of a state’s Amended Credit for Reinsurance Model Law and Regulation, but only with respect to losses incurred and reserves reported on or after the reinsurer’s eligibility date or the inception, renewal or amendment date of such reinsurance agreement, whichever is later. Therefore, losses incurred and reserves reported prior to the zero collateral effective date for any Eligible Reinsurer with respect to runoff, as well as new, amended or renewed reinsurance agreements will remain subject to credit for reinsurance collateral requirements applicable to the reinsurer absent its status as an Eligible Reinsurer.

⁴ On December 19, 2019, the U.S. and U.K. signed the Bilateral Agreement between the United States of America and the United Kingdom on Prudential Measures Regarding Insurance and Reinsurance which is substantially the same as the U.S./EU Covered Agreement. The parties plan to bring the bilateral agreement into force once the U.K. is no longer subject to the U.S./EU Covered Agreement and internal processes have been adopted by the parties.

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Notwithstanding the Covered Agreement and the Amended Model for Reinsurance Law and Regulation, the parties to a reinsurance agreement may agree on commercially negotiated requirements for security or other terms in the reinsurance agreement that are consistent with law.

b. Timing

The NAIC acted quickly in adopting the Amended Credit for Reinsurance Model Law and Regulation on June 25, 2019. The NAIC plans, in 2020, to make the models an accreditation standard effective as of September 1, 2022. State adoption of the Amended Model for Reinsurance Law and Regulation is driven by dates set forth in the Covered Agreement including the timing of FIO's preemption authority. FIO is authorized to cause the preemption of any state law that is inconsistent with the Covered Agreement, and its work in this regard must begin no later than March 1, 2021 and end on September 1, 2022. FIO is required to prioritize states with the highest volume of gross ceded premium for its preemption determinations.

c. How Changes to U.S. Group Supervision are Part of the Covered Agreement Equation

The Covered Agreement also drove changes to group capital standards, and group capital was therefore a significant initiative for the NAIC in 2019. The Covered Agreement addresses group supervision at the level of an insurance group's worldwide parent. The jurisdiction where the worldwide parent is domiciled or headquartered is called the "Home Supervisor," and any other jurisdiction in which the group has insurance operations is referred to as the "Host Supervisor." The general principle is that group regulation at the level of the group's worldwide parent is to be undertaken *only* by the Home Supervisor. Therefore, a group whose worldwide parent is domiciled or headquartered in the E.U. is subject to worldwide supervision only by the E.U., whereas a group with a U.S. worldwide headquarters is subject only to U.S. worldwide supervision. However, this principle is subject to certain exceptions that have required the NAIC to focus on establishing a group capital tool in 2019. (See Section VII.A.i above for a description of the U.S. group capital tool.)

Specifically, the prohibition against a Host Supervisor imposing a group capital assessment or requirement at the level of a worldwide parent is not absolute—it is contingent on the worldwide parent being subject to a group capital standard by its Home Supervisor. Under the Covered Agreement, the E.U. agreed not to apply its Solvency II group capital requirement to U.S.-headquartered groups (with E.U. operations) for a period of 60 months. However, in the absence of a U.S. group capital assessment tool after the expiration of such five-year period, E.U. insurance supervisors would be able to impose a group capital assessment at the level of the U.S.-based worldwide parent. Accordingly, in 2019 the NAIC adopted a group capital assessment tool based on an RBC aggregation method and in mid-2019 performed initial testing with over 30 U.S. insurance groups. The NAIC group capital assessment will be revised based on the test results and is expected to be adopted by the NAIC in late 2020. However, as noted in Section VII.A.i above, whether the NAIC's group capital standard is equivalent to other international standards is currently an open question.

ii. How the NAIC Extended the Covered Agreement to Other Reinsurers

What started as an NAIC exercise to eliminate reinsurance collateral obligations in order to conform with the Covered Agreement grew to encompass additional classes of reinsurers. Specifically, qualifying U.S. reinsurers domiciled in NAIC-accredited states, and qualifying non-U.S. reinsurers domiciled in a "Qualified Jurisdiction Reciprocal Jurisdiction" (each referred to herein as "Eligible Reinsurers") will be entitled to collateral treatment with respect to reinsurance agreements and related losses and reserves in the same manner as E.U. Eligible Reinsurers. Eligible Reinsurers domiciled in the E.U., Qualified Jurisdiction Reciprocal Jurisdictions and U.S. NAIC-accredited states are subject to the same qualifying credentials except with respect to specific minimum solvency or capital ratios which are jurisdiction-specific.

In late 2019, the NAIC published its first list of Reciprocal Jurisdictions which includes (i) non-U.S. jurisdictions that are subject to an in-force covered agreement with the U.S.

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(i.e., the U.S./EU Covered Agreement); (ii) three Qualified Jurisdiction Reciprocal Jurisdictions (i.e., Bermuda, Japan and Switzerland); and (iii) U.S. states that are currently accredited by the NAIC.

Not all reinsurers or reinsurance agreements will be entitled to collateral elimination. In fact, legacy collateral reinsurance provisions were retained in the Amended Credit for Reinsurance Law and Regulation and will continue to apply to certain U.S. and non-U.S. reinsurers, depending on their U.S. regulatory status and other factors. For the benefit of our readers we have included as an insert to this report several charts that generally describe the various credit for reinsurance standards that co-exist after the adoption of the Amended Credit for Reinsurance Law and Regulation.

E. European and U.K. Regulatory Developments

i. Brexit

a. Introduction

The year 2019 was a politically turbulent year in the U.K., largely because of Brexit. The U.K. Parliament was often deadlocked and the U.K. Government, without a majority in Parliament, was unable to get its way; politicians across traditional political divides formed unprecedented alliances and many Conservative grandees, including two former Chancellors of the Exchequer, were expelled from the parliamentary Conservative party for voting against the Conservative government. Theresa May's attempts to persuade Parliament to approve the Withdrawal Agreement that she had negotiated failed and eventually she paid the price and resigned as Prime Minister. Boris Johnson was elected leader of the Conservative party and hence Prime Minister but found that one of his first actions, to prorogue Parliament for a period from September to the end of October (the then deadline for leaving the E.U.) was found to be unlawful by the Supreme Court and of no effect. In effect, he had been found to have misled the Queen about the propriety of asking her to prorogue Parliament. On its return, Parliament took control of the agenda and passed a law that forced the U.K. government to seek a further extension to the deadline to January 31, 2020 with

the possibility of forcing a further request for extension if Parliament has not approved the Withdrawal Agreement by that time. Parliament had asserted its view that the U.K. should not leave the E.U. without a deal.

In the meantime, amendments to the Withdrawal Agreement were agreed with the E.U., which dealt with the thorny issue of maintaining an open border between Northern Ireland and the Republic of Ireland. Amendments were also made to the draft Political Declaration that would form the route map for negotiating the long-term arrangements between the U.K. and the E.U. post Brexit. These changes were sufficient to obtain initial approval from Parliament to a draft E.U. (Withdrawal Agreement) Bill (the "WAB") that would have to be passed in order for the Withdrawal Agreement to be ratified and come into effect. Perhaps fearful of the possibility of Parliament seeking to make amendments to the WAB contrary to the Government's wishes, the Prime Minister persuaded Parliament to agree to a general election. The election was held on December 12 and resulted in the Conservative Party winning a comprehensive victory and a majority in Parliament of 80 seats. The days of Parliamentary deadlock have now passed and it is pretty much certain that the WAB will be passed before the end of January, and accordingly the U.K. will formally leave the E.U. after more than 47 years on 11 p.m. January 31, 2020, which, for the purposes of much U.K. legislation will be designated "exit day."

Following exit day, the U.K. will cease to be a member of the E.U. but it will continue to follow E.U. rules, and contribute to the E.U.'s budget, during an 11-month transition period that will expire at the end of December 2020. Attention will now turn to the Political Declaration and the terms of future long-term relationship between the U.K. and the E.U.

Fresh with his Parliamentary majority and election campaign slogan to "Get Brexit Done," Boris Johnson has insisted that the implementation period will not be extended. Indeed the draft WAB was amended, among other things, to expressly prohibit as a matter of law the U.K. making a request to extend the transition period beyond the end of the year. A full comprehensive trade deal of the extent and complexity that applies to the U.K. and E.U. has not been negotiated in

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11 months in history. The new E.U. Commission President, Ursula von der Leyen, stated in her recent visit to the U.K. that she thought such a task was impossible. Most independent commentators agree. As a consequence, the two parties will have to prioritize their objectives. It appears that the priorities will be trade in manufactured goods, security and commercial fishing. In terms of services, we think it unlikely that a comprehensive agreement will be reached by the end of 2020, which means that for insurers and reinsurers incorporated and headquartered in the U.K., they will be residing in a “third country” as from January 1, 2021 and will not have any “passporting” rights to the E.U. single market in insurance and reinsurance.

Building upon our review last year, we consider below how Brexit will affect the way in which the insurance industry is regulated both in the immediate and longer term.

b. Onshoring of E.U. Legislation

As part of its Brexit preparations, Parliament has passed the European Union (Withdrawal) Act 2018 (“EUWA”). This Act will repeal the European Communities Act 1972, preserve existing U.K. laws which implement E.U. obligations and convert existing directly applicable E.U. law at the point of exit into U.K. law (as “retained E.U. law”). The EUWA also confers powers on Government ministers to make changes to the law so that it continues to operate effectively after the U.K. has left the E.U. (and after any transition period has expired). HM Treasury has elected to delegate powers under the EUWA to the FCA and the PRA to amend and maintain existing E.U.-derived provisions currently in the FCA Handbook and the PRA Rulebook (as applicable) and Binding Technical Standards in order to ensure that domestic regulation functions effectively once the U.K. is no longer subject to E.U. rules.

In the longer term, certain functions that are currently performed by European regulators such as EIOPA will be transferred to the FCA and the PRA. Of particular importance to insurers is the transfer to the PRA of the responsibility to publish Solvency II technical information. The PRA has stated that, as far as possible, it intends to perform this function in the same way as is currently being

performed by EIOPA in order to minimize any disruption to U.K. firms.

c. Political Declaration

The effect of Brexit on the insurance industry will depend upon the level of access to the European market that U.K. insurance firms enjoy under the terms of any trade deal agreed with the E.U. before the end of the transition period. However, this position is currently unclear.

The U.K. and E.U.’s “Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom,” the non-binding preliminary text to the Withdrawal Agreement, states that the parties will seek to create a “level playing field for open and fair competition” which will “facilitate trade and investment between the Parties to the extent possible.” The U.K. and the E.U. also will aim to ensure that financial services are covered by “ambitious, comprehensive and balanced arrangements” which will “deliver a level of liberalization in trade in services well beyond the Parties’ World Trade Organization (WTO) commitments” and which will substantially remove all discrimination between the jurisdictions. However, the Declaration also recognizes the autonomy and ability of each party to “regulate economic activity according to the levels of protection each deems appropriate.”

Any agreement by the E.U. to recognize aspects of U.K. insurance regulation as “equivalent” would be affected by the level of regulatory alignment maintained by the U.K. to the E.U.’s standards and rules. The E.U. has stated that it would be prepared to grant the U.K. access to the E.U. market through “equivalence” decisions, provided that the U.K. does not start to engage in regulatory divergence. However, Boris Johnson has recently stated that he would not be prepared to agree to full regulatory alignment, as this would tie the U.K.’s hands in future trade deal negotiations with other countries. Furthermore, the Governor of the Bank of England, Mark Carney, has stated that it would not be appropriate for a financial services sector of the size of the U.K.’s, to effectively be a rule-taker from the E.U. How these contradictory pressures of market liberalization and

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access on the one hand and complete regulatory autonomy on the other hand will be reconciled remains to be seen.

In the absence of a sufficiently comprehensive deal on services between the E.U. and the U.K. by the end of the transition period, the parties would regard each other as “third countries” for the purposes of insurance regulation and affected undertakings would face hurdles to cross-border commerce. In practice, we do not consider that the wholesale reinsurance sector in the U.K. will be significantly affected, because even in the absence of a finding of “equivalence” for reinsurance purposes, European cedants will still be able to obtain capital benefits from U.K. reinsurers that are well-rated. Commercial realities demand that reinsurers, in any event, have a good rating in order to do business. For U.K. groups that wish to provide insurance throughout the E.U. after 2020, they will likely need to find solutions involving an E.U. presence. Most groups in this situation have already taken steps to do so but inevitably some players in the market will have to put in place solutions in the course of 2020.

ii. Extension of the SM&CR to Insurance Intermediaries

In last year’s insurance industry review, we reported on the extension of the Senior Managers & Certification Regime (the “SM&CR”) to insurers. The SM&CR was further extended to insurance intermediaries on December 9, 2019. By this deadline, affected firms had to identify and register their Senior Managers with the FCA, as well as agree on statements of responsibility with them. Large firms, with a three-year rolling average revenue of £35 million, also were required to prepare a Responsibilities Map, which sets out their governance and management arrangements and the allocation of responsibilities among individuals within the firm.

However, intermediaries are otherwise able to benefit from a 12-month “grace period” in which to complete their initial rounds of annual assessments of the fitness and propriety of employees carrying out Certification Functions. They also will have 12 months to train all staff (other than Senior Managers and Certification Staff) on the SM&CR Conduct Rules.

Despite the lengthy lead-in to this new regime, it is possible that a number of insurance intermediaries were not ready to comply with the SM&CR on the date that it came into force for solo-regulated firms. In April 2018, Ecclesiastical reported that only two-thirds of intermediaries were aware of the impending rollout of the SM&CR for insurers and one in seven insurance intermediaries claimed that they felt informed about the upcoming SM&CR requirements. Further, less than half of those intermediaries interviewed by Ecclesiastical believed that the new rules would improve protection for customers.

If these figures are still representative of a number of intermediaries in the industry, they could indicate a general lack of compliance with SM&CR now that it has come into force. A target intermediary’s compliance with the SM&CR regime may therefore represent a specific focus area for potential purchasers when performing due diligence prior to acquisition. Significant work by the purchaser between exchange and completion (and even after completion) also may be required in order to ensure the intermediary’s compliance with the regime following a change of control.

iii. PRA Consultation Paper on Operational Resilience

In December 2019, the PRA published a Consultation Paper entitled “Operational Resilience: Impact tolerances for important business services,” in which it sets out proposed new rules in its Rulebook designed to improve the resilience of firms from the impact of operational disruptions. The proposed implementation date for these rules is the second half of 2021. The PRA also intends to publish an accompanying Supervisory Statement and a Statement of Policy at the same time.

“Operational resilience” is defined as the ability of firms and the financial sector as a whole to prevent, adapt, respond to, recover and learn from operational disruptions. The PRA is concerned that many firms may not sufficiently plan on the basis that disruptions will occur, and are therefore not ready to effectively manage any disruptions that may arise.

The proposed rules are intended to establish an objective basis for the PRA to assess firms’ operational resilience

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and will be a reference point where it determines that enforcement action is necessary to address a perceived fragility in a firm's operational structure.

The PRA intends that firms will improve their operational resilience in three main areas:

- (1) boards and senior management must prioritize those activities that, if disrupted, would pose a risk to: the U.K. financial sector (such as lines of cover that are compulsory across an industry); the firm's own safety and soundness; and the appropriate degree of policyholder protection. Firms are therefore likely to move away from monitoring the resilience of individual systems and instead will focus on ensuring the continuity of certain services that are provided to third parties;
- (2) firms should be able to set clear standards and targets for operational resilience. These targets should be quantifiable and include time limits within which business services can be resumed. Impact tolerances also should be subject to periodic scenario testing; and
- (3) firms should have contingency arrangements in place to enable them to resume the delivery of important business services.

As a result of these rules, firms should be better placed to identify important business services, set impact tolerances and ensure that they are able to remain within them. Firms also would be required to self-assess in order to identify any vulnerabilities that they may have in the delivery of important business services, such as the limited substitutability of resources and an elevated risk of single points of failure, and how they are being addressed. The PRA would be able to require firms to provide their self-assessments to it for review.

Rules relating to the identification of operational risk and ensuring operational resilience already exist in regulatory handbooks. However, the elevated level of granularity in the PRA's proposed rules are undoubtedly positive for the insurance industry, in which firms' businesses are becoming

increasingly complex and reliant upon third parties such as outsourced service providers (as discussed below). This dynamic increases the importance for firms to remain vigilant in assessing the risks to their businesses. Further, the PRA's ability to request self-assessments will enable it to identify negative trends or systemic issues which could affect the entire financial services sector, such as those witnessed in the banking crisis in the previous decade.

iv. PRA Consultation Paper on Outsourcing and Third-Party Risk Management

In December 2019, the PRA also published a Consultation Paper on "Outsourcing and third party risk management" in addition to its Consultation Paper on operational resilience (above). This consultation paper did not suggest new rules in its Rulebook. Instead, the PRA appended a proposed Supervisory Statement which sets out a modernized framework of expectations relating to outsourcing activities and third-party risk management. The PRA aims to finalize this Supervisory Statement in the second half of 2020.

The PRA's proposals relate to all types of outsourcing. However, they particularly focused on the use of cloud technology, due to firms' increased reliance upon it to reduce operating costs, gain entry into new markets and increase innovation. The PRA stated that, while the increased use of cloud and other outsourced technology can improve operational resilience, it may pose data and cyber security risks due to the storage of significant volumes of personal data on third-party systems. The PRA is also concerned that boards and management may not fully understand the nature of operational risks to their business as the technology used in outsourced activities is often evolving at a rapid rate. Further operational risk may arise where firms have a widespread dependency on services provided by only a small number of dominant operators; creating exposure to disproportionate exit costs or increasing the risk of significant harm caused by a single point of failure.

The PRA's expectations in relation to outsourcing activities include:

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- (1) Governance—board engagement in relation to the firms' outsourced activities should be increased, particularly as individuals performing Senior Management Functions cannot outsource their regulatory responsibilities. Boards should set the control environment for outsourcing and should bear responsibility for effective management relating to outsourcing risks. Firms also should not become "empty shells" and must remain capable of being effectively supervised by the PRA.
- (2) Record-keeping—insurers may be required to maintain a cloud register from December 1, 2020, under the EIOPA Cloud Guidelines. The PRA is considering providing guidance on how certain fields of this register should be completed.
- (3) Pre-outsourcing phase—the Supervisory Statement introduces common criteria for firms' assessment relating to the risks posed by "material outsourcing" in order to improve consistency across the sector. The PRA also clarifies that it expects firms to notify it of material outsourcing arrangements sufficiently in advance of entering into the relevant agreement to allow for appropriate supervisory scrutiny.
- (4) Due diligence and risk assessment—new expectations have been placed on firms' due diligence of prospective service providers. The PRA also highlights the importance of firms assessing the risks of all outsourcing arrangements irrespective of their materiality.
- (5) Outsourcing agreements—the PRA expects that "material outsourcing" arrangements must include provisions which satisfy its expectations relating to: data security, access, audit and information rights, sub-outsourcing and business continuity and exit plans.

These expectations apply equally to intra-group outsourcing and to third-party providers, which the PRA regards as carrying the same level of risk. However, the PRA states

that a proportionate approach could be adopted in relation to intra-group outsourcing depending upon the level of "control and influence" that the outsourcing company has on the service provider. This could mean that the outsourcing company may adjust its vendor due diligence, or group policies and procedures could be adopted if they assist the outsourcing company to manage relevant risks (e.g., cyber and data security).

This proposed Supervisory Statement is likely to provide tangible assistance to boards and managements of insurers when making decisions relating to outsourcing, which is becoming increasingly common and operationally complex. The Supervisory Statement also provides important clarification to insurers as to when the PRA is likely to initiate enforcement action in the event of a perceived regulatory breach.

v. The PRA's Framework for Assessing the Financial Impacts of Physical Climate Change

The PRA's framework for assessing the financial impacts of physical climate change was published in May 2019 following input from an industry-wide working group of experts in the (re)insurance industry that was established by the Bank of England.

The framework is intended to provide practical assistance to insurers in developing scenarios, strategies and risk management approaches relating to physical climate change, as well as ensure a minimum level of consistency of approach across the sector. Despite the increasing risk to insurers posed by climate change, the PRA has identified that the tools, techniques and methodologies used by insurance practitioners to assess these risks vary in their maturity across the sector.

The financial risk to insurers caused by climate change has been a recent focus for the PRA and the FCA. In March 2019, the PRA and the FCA established a Climate Financial Risk Forum ("CFRF"), in which stakeholders from across the financial services sector build capacity and share best practices in order to advance the sector's responses to the financial risks from climate change. The CFRF has now

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met on three occasions in March, July and November 2019 and aims to publish finalized practical guidance to firms in spring 2020.

The PRA also has published a Supervisory Statement⁵ that sets out its expectations for how banks and insurance companies should manage financial risks caused by climate change. The Supervisory Statement was not prescriptive in nature, as the risks caused by climate change are not yet fully understood. However, the PRA was clear that it expected firms to embed these considerations into their governance arrangements. Suggested actions included identifying a senior manager with responsibility for managing these risks and incorporating its assessment of these risks into reporting documents such as ORSAs.

The framework has six stages that practitioners should follow to assess the financial risk to climate change. These stages are as follows:

- (1) Identify business decisions—firms should identify the relevant context for the climate change analysis, such as: a business strategy (e.g., a merger or acquisition); product development; underwriting and pricing; or risk appetite setting (including a reinsurance purchase decision). The time horizon over which impacts are to be assessed also should be defined and firms should consider whether their focus is on expected or extreme losses.
- (2) Define materiality—firms should adopt a proportionate approach to assessing climate change risk across their insurance portfolio, as these assessments may be a significant task. Focus will be on those areas of the business where climate change could have a material impact for the firm. Relevant considerations will be: the level of the exposure that the firm has to the particular peril; the susceptibility of the peril to climate change; and the interconnectivity between perils or climatic scenarios. For example, certain portfolios or lines of business (such as U.S. hurricane risk)

would be more affected by climate change than other risks.

- (3) Conduct background research—firms should search existing publications to identify and analyze current scientific understanding of how climate change could lead to changes in the frequency, severity and correlation of weather-related perils. The outputs of this research should include: key drivers influencing the severity of a given peril; the impact of climate change on those drivers; and historic trends. This research can then be used as a basis to assess loss impacts to the firm.
- (4) Assess available tools—firms should determine which catastrophe tools would best suit their analysis of the particular climate change risk. Readily available catastrophe risk assessment tools may include in-house probabilistic catastrophe models, hazard maps, footprints and expert judgment.
- (5) Calculate impact—firms should calculate the potential impact of physical climate change on the business decision using appropriate metrics. These calculations should highlight areas of uncertainty in the relevant assessment.
- (6) Reporting and action—firms' quantitative and/or qualitative loss results should be communicated to decision makers in a format that is applicable to the relevant business decision.

The framework also provides insurers with a number of case studies which demonstrate how these stages are applied in practice.

The publication of this document is topical considering the level of devastation caused by recent hurricane seasons and the current wildfires in Australia. Environmental reports also consistently show that natural catastrophes are becoming more frequent and widespread, and that they also are now beginning to occur in new geographic areas. The practical guidance contained within this report (in particular the case studies) will be welcomed by insurers,

⁵ Supervisory Statement SS3/19 April 2019.

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many of whom may not currently have the knowledge or ability to appropriately assess the risks that climate change poses to their business. We also expect that further publications relating to climate change will be published by U.K. regulators and industry working groups over the course of this year.

vi. EIOPA's Consultation on the Opinion on the 2020 Review of Solvency II

In October 2019, EIOPA published its Consultation Paper on the Opinion on the 2020 review of Solvency II, which sets out EIOPA's technical advice for the review of Solvency II. The work of EIOPA is in connection with a requirement under the Solvency II Directive that the E.U. Commission review certain areas of the Solvency II framework by January 1, 2021. The review is wide ranging, but only concerns technical aspects of the Solvency II framework and is not intended to change the fundamental design of Solvency II.

The Consultation Paper covers 19 topics, which can be divided into three parts:

- (1) a review of long-term guarantee measures;
- (2) the potential introduction of new regulatory tools in the Solvency II Directive, notably on macro-prudential issues, recovery and resolution, and insurance guarantee schemes; and
- (3) revisions to the existing Solvency II framework, including in relation to the freedom of services and establishment, reporting and disclosure, and the solvency capital requirement. EIOPA considers that the framework is generally working well and any changes will be more a case of "evolution" rather than "revolution."

EIOPA has acknowledged that this Consultation Paper is a particularly lengthy document, due to the unprecedentedly wide number of topics on which its advice has been sought. It therefore has highlighted the following considerations and proposals as being the main areas of focus:

- (1) considerations to choose a later starting point for the extrapolation of risk-free interest rates for the euro or to change the extrapolation method to take into account market information beyond the starting point;
- (2) considerations to change the calculation of the volatility adjustment to risk-free interest rates;
- (3) the proposal to increase the calibration of the interest rate risk sub-module in line with empirical evidence;
- (4) the proposal to include macro-prudential tools in the Solvency II Directive; and
- (5) the proposal to establish a minimum harmonized and comprehensive recover and resolution framework for insurance.

Industry responses were due by January 15, 2020 and EIOPA's technical advice will be finalized in June 2020.

vii. Lloyd's

The year 2019 was a big year for Lloyd's, with the launch of its Future at Lloyd's strategy. This strategy has the ambitious aim to reform the way the Lloyd's market operates, modernize it in many ways and position the market for the future. It follows some turbulent results in 2017, where the market as a whole suffered a £2 billion loss, followed in 2018 by another loss of £1 billion. The high expense ratios in the Lloyd's market have been a perennial problem. The year 2019 is looking like a return to healthy profitability in the market, due in part to favorable claims experience and, no doubt, to some of the measures that Lloyd's has been undertaking in recent years to improve the performance of the market and, in particular, lower performing syndicates.

The future strategy is a product of the change in senior management of Lloyd's. Bruce Carnegie-Brown assumed his position as chairman of Lloyd's in the middle of 2017 and John Neal, the CEO, assumed his position in October 2018. The announcement of Neal's appointment as the new CEO heralded his expertise in business transformation and

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he and the Lloyd's management team have lived up to that reputation in the work carried out in 2019.

The new leadership team sponsored a thorough review of the Lloyd's market, its processes, what it considered its strengths and weaknesses and what its customers and market practitioners valued in the market and saw as areas needing change. This review resulted in the publication of a Lloyd's prospectus in May 2019 entitled "The Future of Lloyd's." This prospectus identified six key areas that the market should focus on in its reform program. These areas were creating an easier way for insuring complex risks; streamlining and automating the placing of more common risks in order to reduce costs; opening up a different range of capital providers making it easier for them to enter the market; the creation of the idea of a "syndicate in a box," which is intended to provide a fast-track way for particularly innovative firms to enter the market easily; vastly improved claims service; and, finally, changes to the culture of Lloyd's market with the intention of encouraging innovation and inclusivity in the market.

Lloyd's then consulted stakeholders in the market over the course of the summer. Out of that extensive consultation, a major publication entitled "The Future of Lloyd's, Blueprint One" was published in September 2019, expanding on and describing in more detail the proposals first floated in the May prospectus. Then at the end of 2019, Lloyd's announced that (i) it had raised £300 million of senior debt in order to help fund the transformation work that the Future of Lloyd's plans would entail and (ii) it had established a governance structure around the implementation of the proposals.

While all commercial organizations have to constantly consider their business strategies for facing the future, it is interesting to note how Lloyd's as a marketplace has thoroughly embraced a program of change in its Future of Lloyd's Blueprint One proposals. Introducing such a comprehensive plan for change into a market made up of individual businesses presents unique challenges for Lloyd's, yet we discern market acceptance of the program, which is a testament to the market's desire for change as a whole and the handling of the consultation exercise. One can discern various key influencing factors. First of

all, the rise of fintech or insurtech in recent years and so-called market disruptors have affected Lloyd's in the sense of inspiring a desire to be able to embrace innovation and change in an agile way, which the market has struggled to do in the past. Technology and data analytics are again major drivers of these proposals. Technological advancement in the insurance market, as elsewhere, has the potential to improve business efficiency and mode of operating radically. Data analytics has been increasingly important in the reinsurance industry and Lloyd's is seeking to embrace it in a different way.

It is also interesting to note the emphasis on culture. In the past when one thought of the culture of Lloyd's, one immediately thought of lunchtime drinking in the pubs in Leadenhall Market. That is a different universe from what is envisaged in the Future of Lloyd's. The intention is to embrace diversity, innovation and a feeling of inclusiveness, with the intention of using these features to improve the market's overall performance and attract talent, particularly among younger people. The concern is that there is an age gap in the leadership of the market and as current leaders move towards retirement insufficient talent would be available to replace those individuals.

It is also worth noting that some undesirable traits in the Lloyd's market came to light in the course of 2019, namely accusations of sexism and bullying. It is perhaps no surprise, and to be welcomed, that Lloyd's has placed a high profile focus on improving the culture in the Lloyd's marketplace.

The proposals also focus on traditional areas of concern. The processing of claims at Lloyd's has been laborious and inefficient, as recognized in the proposals put forward in the Future of Lloyd's. The matching of capital to risk has been a perennial issue for Lloyd's. The new proposals are intended to make it easier for capital providers to provide their capital and in more flexible ways such that they could limit the duration of capital provision and be able to withdraw their capital more easily. Another interesting proposal is the idea of using the new U.K. ILS regime as a complementary way for capital providers to direct their capital into the Lloyd's market. How this will develop will be interesting to see; we understand that the use of cell structures to provide capital

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to corporate lenders is being discussed. The proposals also talk about a central capital platform that increases the ease of matching risk and capital. It is clear that Lloyd's would welcome more capital sourced from ILS funds, sovereign wealth funds and pension funds in more direct ways than has hitherto been the case.

It is also worth highlighting the concept of a "syndicate in a box." The objective is to attract into the market innovative new business enterprises and give them a period to operate in Lloyd's to help establish their business. A series of rules around syndicate in a box processes will be needed. This concept is very much aimed at innovation and new product development and not necessarily at what one might call traditional syndicate business plans.

In all of these cases, but particularly the last two that we have mentioned, we as lawyers are conscious that changes to rules and Lloyd's documentation will be needed. At the time of publication, these rules have not been changed, but we would expect to see changes being developed during the course of 2020.

Lastly, the Blueprint One document is also notable for its emphasis on delivery of the plans and seeking to ensure that the initial objectives are delivered first before moving on to further objectives or developments. Lloyd's also wishes to preserve its flexibility in changing the implementation of its proposals as they go along.

These proposals certainly represent a significant change to the way that Lloyd's operates. On the technological front Lloyd's has had a checkered history in introducing market-wide technological changes. These proposals, which have been preceded by extensive market consultation, would hopefully not suffer the same problems as in the past and will result in Lloyd's modernization. The document embraces current commercial thinking and modern jargon and is peppered with much on-trend terminology. Nonetheless, we think that it is to be welcomed that Lloyd's is seeking to modernize, and the feedback we have received from clients has been overwhelmingly positive. As mentioned above, we will closely monitor how in concrete terms changes to Lloyd's rules and documentation will be introduced to

enable these proposals to be implemented, and we look forward to working with our clients in the Lloyd's market in the course of 2020.

viii. Euro Risk-Free Rate Reform

The benchmarks reform has been a 'hot topic' over the last few years. Although the industry is bracing itself for the transition away from LIBOR, the extent of the actual proposed amendments has been limited. Benchmarks are an important component of any transaction in the insurance industry and have wide-ranging implications on capital raising transactions, mergers and acquisitions as well as risk-transfer transactions.

The International Capital Market Association ("ICMA") has placed increased importance on the transition to risk-free rates in Europe and in March 2019 has officially commenced the transition process from Euro OverNight Index Average ("EONIA") to euro short-term rate ("€STR") with the recommendation that €STR is to replace EONIA in all live and future contracts. The EONIA administrator, the European Money Markets Institute ("EMMI"), consulted and confirmed that EONIA will be discontinued on January 3, 2022. EMMI has also published the initial fallbacks for EONIA to include €STR plus a fixed spread. In consultation with the European Central Bank ("ECB"), EMMI has calculated the spread between EONIA and €STR as 0.085% (8.5bps) as being the applicable spread, which is to be used for the EONIA moderation for all products and services.

Following the cooperative process with EMMI, the ECB officially published €STR for the first time on October 2, 2019. Following the publication, the ECB issued guidance that for any existing contracts maturing after December 2021 market participants should replace EONIA as soon as possible or embed robust fallbacks.

The transition to risk-free rates for euro-denominated contracts is far from over. However, we welcome the recent increased activity in this sphere and the publication of detailed fallbacks for use in EONIA-marked contracts,

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which provide market participants with much needed certainty.

ix. E.U. and U.K. Competition Law

Following the opening of a number of significant new cases and market studies in 2018, the insurance sector continued to be under scrutiny from competition authorities in the U.K. and the E.U., with the U.K. Competition and Markets Authority (“CMA”), the FCA and the European Commission announcing new cases and/or continuing multiple investigations.

a. European Commission’s Investigation of Insurance Ireland

Following its dawn raids in July 2017, the European Commission (“Commission”) continued its investigation into the allegedly anticompetitive conduct of certain automotive insurers in Ireland, formally opening a case in May 2019 against Insurance Ireland, a trade association whose members include Allianz, Liberty, AIG, and AXA, among many others.

Competition authorities in Dublin have taken action in the sector in recent years, culminating in binding commitments in 2016 by leading insurers to restrict their exchanges of competitively sensitive information via intermediary software systems. A parallel investigation into price signaling by motor insurance firms, according to the Irish authorities, was at an “advanced stage” in December 2019.

The Commission’s investigation of the sector in Ireland—an unusual step into a national market—is focused not on the exchange of information but instead the conditions of access to it. In particular, the Commission is investigating whether insurers wishing to offer their services on the Irish motor insurance market may have been unlawfully prevented from accessing data pools controlled by Insurance Ireland.

Those pools, comprised of members’ claims data, are designed to facilitate the detection of fraudulent behavior and to ensure the accuracy of information provided by

customers. The Commission has acknowledged the capacity of such data pools to promote market entry and to improve choice. However, it also contends that the conditions for access must not be used to exclude competitors.

The Commission has no legal deadline for reaching a decision in the case, and may conduct further requests for information or raids before issuing any formal charges via a statement of objections.

b. Antitrust Complaint to European Commission in Relation to AmTrust’s Take-private

Krupa Global Investments (“KGI”), a Czech private investment firm, announced in February 2019 that it had submitted an antitrust complaint to the Commission concerning AmTrust and Stone Point Capital (“SPC”), which managed private funds involved in the take-private of AmTrust, valued at US\$2.95 billion. The antitrust complaint follows litigation launched by KGI in Delaware Chancery Court in June 2018.

KGI has alleged that AmTrust, managed by its founders, breached competition rules by exchanging competitively sensitive information with other insurers, including those controlled by SCP, and coordinating its commercial conduct with competitors in order to drive down the purchase price to be paid by the founders and SCP for the 45% of AmTrust held in public hands.

KGI continued to oppose the take-private even after fellow investor Carl Icahn succeeded in June 2018 in forcing an upward price revision for the deal, which closed in November 2018. KGI’s antitrust complaint, in order to lead to a formal investigation, must first satisfy the Commission’s threshold of a sufficient E.U. interest. The rejection of an unsuccessful complaint could also be challenged by KGI before the E.U. courts.

c. CMA Investigation into MFNs in Home Insurance Products

The CMA announced in December 2019 that it aims to take a decision in spring 2020 concerning its investigation of the

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use by ComparetheMarket, an online comparison site, of “most favored nation” clauses in the distribution of home insurance products. In online retailing, such clauses require the provider of a product to offer prices on the platform which are at least as low as the prices listed by rival outlets.

The CMA is concerned that such clauses may prevent home insurers from quoting lower prices on rival sites and other channels. In September 2017, the CMA announced that it had opened an investigation against a number of online hotel booking websites and, in November 2018, set out its formal charges against ComparetheMarket in a statement of objections.

The CMA opened its investigation in 2017 on the basis of evidence obtained during the course of its earlier Market Study on Digital Comparison Tools, completed in the same year. Ahead of reaching its final decision in the case, in 2019 the CMA has gathered further evidence, and considered written and oral representations by ComparetheMarket.

d. FCA Market Study on Wholesale Insurance Brokers

In February 2019, the FCA published the final report in its wholesale insurance brokers market study, concluding that the limited concerns which it had identified could be addressed through the FCA’s ordinary supervisory powers. Launched in 2017, the market study examined how brokers in the £60 billion London Insurance Market compete in practice and any effects which conflicts of interest may have on competition.

While the FCA did not find indications of significant levels of harm, the final report identified areas for modest improvement, including brokers’ disclosures to clients and management of conflicts of interest. The FCA will continue to monitor the market to assess developments arising from the impact of the U.K.’s withdrawal from the E.U., further consolidation in the industry, and any changes in business models.

VIII. TAX TRENDS AND DEVELOPMENTS AFFECTING INSURANCE COMPANIES

A. U.S. Tax Developments: Guidance on the Application of Tax Reform to the Insurance Industry

As discussed in last year's edition of our insurance industry review, the U.S. Treasury Department (the "Treasury Department") and Internal Revenue Service (the "IRS" and, collectively with the Treasury Department, "Treasury") has been issuing guidance to address the many unanswered questions presented by the Tax Cuts and Jobs Act, which was enacted into law at the end of 2017 (the "2017 Act"). The 2017 Act significantly altered the landscape for the international insurance and reinsurance sectors by, among other things, (i) imposing a minimum tax on outbound cross-border affiliate reinsurance (and possibly inbound as well), (ii) revising the rules applicable in determining controlled foreign corporation ("CFC") status of foreign corporations and the U.S. shareholders potentially impacted by the CFC rules and (iii) creating another hurdle for foreign insurers (and foreign parented insurance groups) to qualify for the insurance company exception to the passive foreign investment company ("PFIC") rules. The discussion below highlights guidance provided by Treasury that is particularly relevant in the international insurance and reinsurance space.

i. PFIC Guidance

On July 10, 2019, Treasury released proposed regulations on (a) the application of the Insurance Company Exception (as defined below), which was substantially modified by the 2017 Act and (b) long-awaited guidance on a range of issues relating to PFICs that have been left unanswered since the PFIC rules were introduced as part of the 1986 U.S. tax reform (the "2019 Proposed Regulations"). The 2019 Proposed Regulations, taken together with the 2017 Act, could have substantial ramifications for U.S. investors in offshore insurance and reinsurance structures, including traditional global insurance and reinsurance

corporate structures, insurance-linked securities funds and insurance-linked securities issuers. A U.S. taxable investor in the shares of an offshore insurer or reinsurer group is generally able to defer U.S. taxation until a sale of its shares and, if held long enough, pay tax on such sale at long-term capital rates if, among other things, the offshore insurer or reinsurer group qualifies for the Insurance Company Exception. If the PFIC rules were to apply to a U.S. taxable investor in an offshore insurance or reinsurance structure, the U.S. taxable investor would lose some or all of the benefits of U.S. tax deferral and long-term capital gain treatment. The 2019 Proposed Regulations withdraw prior regulations proposed in 2015 related to the Insurance Company Exception that were widely criticized by the insurance industry as ignoring market practice and realities (the "2015 Proposed Regulations"). The 2019 Proposed Regulations are similarly flawed in some cases (including their use of undefined terms and phrases not commonly used in the insurance industry), and Treasury is again reaching out to the industry for comments in a number of areas.

a. General Summary of the PFIC Rules and the Insurance Company Exception

The Internal Revenue Code of 1986, as amended (the "IRC"), provides that a foreign corporation will be considered a PFIC if in any taxable year either (1) 75% or more of its gross income in such taxable year is passive income (the "Income Test") or (2) the average percentage of assets held by such corporation during the taxable year that produce passive income is at least 50% (the "Asset Test"). Passive income is defined by reference to foreign personal holding company income ("FPHCI") under the CFC rules and includes dividends, interest, royalties, rents and other types of investment income. The PFIC rules provide that income derived in the active conduct of an insurance business by a qualifying insurance corporation (the "Insurance Company Exception") will not be treated as passive income.

The 2017 Act limited the Insurance Company Exception to a non-U.S. insurance company that is a qualifying insurance corporation ("QIC"), which is a foreign corporation that

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would be taxable as an insurance company if it were a U.S. corporation and that either (i) maintains “applicable insurance liabilities” (“AILs”) of more than 25% of such company’s total assets as shown on the company’s “applicable financial statement” (“AFS”) for a taxable year (the “25% Test”) or (ii) maintains AILs that at least equal or exceed 10% of its total assets for the taxable year, is predominantly engaged in an insurance business and satisfies a facts and circumstances test that requires a showing that the failure to exceed the 25% threshold is due to runoff or rating agency circumstances (the “10% Test”). The 10% Test would require a U.S. investor to elect to treat the foreign corporation as a QIC, although the method of election is not prescribed by the IRC. AILs mean (i) losses and loss adjustment expenses and (ii) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks, and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks. The IRC provides a cap on the AILs equal to the lesser of the amount reported to the applicable insurance regulatory body in the AFS (or, if less, the amount required by applicable law or regulation) or as determined under Treasury regulations. The AFS is a statement for financial reporting purposes that is made on the basis of GAAP or IFRS (if no statement is prepared for financial reporting purposes on the basis of GAAP). If no statement is prepared for financial reporting purposes on the basis of GAAP or IFRS, the AFS would be the annual statement required to be filed with the applicable insurance regulatory body (except as otherwise provided in Treasury regulations). The “applicable insurance regulatory body” means, with respect to any insurance business, the entity established by law to license, authorize or regulate such business and to which an annual statement is provided. The QIC test could result in the application of the PFIC rules to offshore insurance and reinsurance structures that write business on a low frequency/high severity basis and take on significant insurance risk, such as property catastrophe companies (including ILS funds) and financial or mortgage guaranty companies that generally do not book reserves for losses until a catastrophic or credit event occurs. This result seems at odds with the legislative purpose underlying the modifications to the Insurance Company Exception, since

these are not companies conducting a token insurance business while focusing primarily on investment activities.

For purposes of the Asset Test and Income Test, a foreign corporation will be considered to (1) hold its proportionate share of the assets of a corporation and (2) directly receive its proportionate share of the income of a corporation if the foreign corporation owns, directly or indirectly, at least 25% (by value) of the stock of the other corporation (the “Look-Through Rule”).

A special characterization rule also applies to the determination of whether a foreign corporation is a PFIC where such foreign corporation owns at least 25% (by value) of the stock of a U.S. corporation, which in turn holds the stock of another U.S. corporation other than a regulated investment company or a real estate investment trust (“qualified stock”). Under this provision, in determining whether a foreign corporation is a PFIC, (1) the stock of the second-tier U.S. corporation held by such first-tier U.S. corporation will not be considered to be an asset that produces passive income and (2) dividends from such second-tier U.S. corporation to the first-tier U.S. corporation will not be treated as passive income, provided that the foreign corporation is subject to the accumulated earnings tax (the “Special Characterization Rule”).

The application and coordination of the Look-Through Rule and the Special Characterization Rule are not statutorily addressed and may produce different results in analyzing whether a foreign corporation should be treated as a PFIC.

b. Proposed Regulations on Insurance Company Exception

As noted above, the Insurance Company Exception would only apply to income derived in the active conduct of an insurance business by a QIC. The 2019 Proposed Regulations provide guidance on the three requirements—QIC status, insurance business and active conduct.

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i) QIC Status

(1) General Test

A foreign corporation will be treated as a QIC if it would be taxed as an insurance company under subchapter L if it were a domestic corporation and its AILs meet the 25% Test (or the 10% Test, assuming the U.S. investor elects to treat the foreign corporation as a QIC). The 2019 Proposed Regulations define an insurance company by reference to the IRC—that is, as a company more than half the business of which during the taxable year is the issuance of insurance or annuity contracts or the reinsurance of risks underwritten by insurance companies. The 25% Test will be met if the amount of the foreign corporation's AILs exceeds 25-percent of its total assets based on the corporation's AFS for the last year ending with or within the taxable year.

The 2019 Proposed Regulations define AILs as (1) occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year, including unpaid claims for death benefits, annuity contracts and health insurance benefits, together with unpaid expenses (including reasonable estimates of anticipated expenses) of investigating and adjusting such unpaid losses and (2) the aggregate amount of reserves (excluding deficiency, contingency or unearned premium reserves) held for future unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity risks, including annuity benefits dependent on life expectancy of one or more individuals. The meaning of "occurred losses" (which is not a term of art in the insurance industry) is unclear, as is the requirement that the foreign corporation has become liable for such losses before the end of the last annual reporting period (which presumably does not mean a final determination as to the liability and amount).

The 2019 Proposed Regulations further tightened the AIL cap in the IRC by providing that the amount of AILs may not exceed the lesser of (1) the amount of AILs shown on the most recent AFS, (2) the minimum amount of AILs required by the applicable law or regulation of the jurisdiction of the

applicable regulatory body, or (3) in the case of a foreign corporation that prepares a financial statement on the basis of a "financial reporting standard" (defined as U.S. GAAP or IFRS) for a purpose other than financial reporting, the amount of the AILs shown on that financial statement (on the theory that Congress has expressed a preference for widely used standards of financial accounting). Treasury found it appropriate to limit the amount of AILs to the minimum amount required to be reported to the insurance regulator, even if the regulator would accept a higher amount for regulatory purposes.

Further, if the AFS is not prepared on the basis of U.S. GAAP or IFRS and the AILs are not discounted on an economically reasonable basis, the AILs must be discounted under U.S. GAAP or IFRS principles. The preamble to the 2019 Proposed Regulations sets out the facts and circumstances that are to be considered in the determination of whether AILs are discounted on an economically reasonable basis (for example, discounting must be based on loss and claim payment patterns for either the foreign corporation or insurers in comparable lines of business). Finally, if a foreign corporation has prepared financial statements on a U.S. GAAP or IFRS basis prior to December 22, 2017 or any subsequent annual reporting period and switches to a method other than U.S. GAAP or IFRS without a non-U.S. federal tax business purpose, it will be treated as having no AILs for purposes of the QIC determination.

For purposes of the 25% Test and the 10% Test, total assets are the aggregate end-of-period value of the real property and personal property that the foreign corporation reports on its AFS for the last annual accounting period ending with or within the taxable year.

(2) Alternative Facts and Circumstances Test

As discussed above, a U.S. person can elect to treat stock in a foreign corporation as stock of a QIC if the 10% Test is met. The 2019 Proposed Regulations provide guidance on the 10% Test requirements.

(i) Predominantly Engaged: A foreign corporation would be considered predominantly engaged in an

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insurance business despite the low ratio of ALLs to assets if it meets the insurance company test described above and satisfies an additional facts and circumstances test to establish that certain facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's-length transactions. The relevant facts and circumstances include claims payment patterns, loss exposure as calculated for a regulator or rating agency (or, if not, for internal pricing purposes), the percentage of gross receipts constituting premiums and the number and size of insurance contracts issued or reinsured. Negative factors that would influence the "predominantly engaged" analysis include a small number of insured risks with low likelihood but large potential costs, low loss exposure and a greater focus on investment relative to underwriting by employees and agents of the foreign corporation.

(ii) *Runoff-Related or Rating-Related Circumstances:* The 2019 Proposed Regulations provide that runoff-related circumstances occur when a foreign corporation (1) has adopted a plan of liquidation or termination of operation under the supervision of its applicable insurance regulatory body; (2) does not issue new contracts during the taxable year (other than certain contractually obligated renewals of existing contracts); and (3) makes claims payments during the annual reporting period covered by the AFS and such payments cause the corporation to fail the 25% Test (the preamble did not indicate that the payments must cause the failure to meet the 25% Test as a consideration to the application of the runoff-related circumstances test).

The 2019 Proposed Regulations also provide some color with respect to rating-related circumstances, although the terminology is not commonly used in the insurance industry. A rating-related circumstance occurs when a generally recognized credit agency requires the foreign corporation to maintain a surplus of capital to receive or maintain a minimum credit rating for the foreign corporation to be classified as secure to write new insurance business for the current year. Because some lines of insurance business require higher minimum credit ratings than others, the preamble to the 2019 Proposed Regulations expresses the intent to apply the highest minimum credit rating required

to be classified as secure to write new insurance business for any line of insurance business (presumably to provide relief to foreign insurers writing multiple lines). Treasury acknowledged that in the case of certain lines of business, such as financial guaranty, market reality may require a credit rating higher than the minimum, but did not address that situation.

(iii) *Election Mechanics* – The 2019 Proposed Regulations provide that the foreign corporation with respect to which the election is made must directly provide the electing U.S. person with a statement or make a publicly available statement (such as in a public filing, disclosure statement or other notice to U.S. shareholders of the foreign corporation) that it met the 10% Test, including certain information relevant to this statement (which cannot be relied upon by a U.S. person who knows or has reason to know the statement was incorrect). The U.S. person would need to make the election on Form 8621 for each year in which the election applies (together with the statement provided by the foreign corporation) and check the box regarding the QIC election. Comments were requested to reduce the burden on small shareholders with respect to this election.

ii) Insurance Business

The 2019 Proposed Regulations define insurance business as the business of issuing insurance or annuity contracts and/or reinsuring risks underwritten by other insurance companies, including investment activities and administrative services required to support or substantially related to those contracts. For this purpose, investment activity means any activity to generate passive income, but only to the extent that income provided by the activity is generated by assets that a QIC holds that are available to satisfy its liability under insurance or annuity contracts issued or reinsured by a QIC. As all of the assets held by a QIC presumably are available to satisfy its insurance liabilities, the limitation in the latter part of the definition of investment activity appears unnecessary.

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iii) Active Conduct of an Insurance Business

The 2019 Proposed Regulations provide that the Insurance Company Exception to passive income applies to income that a QIC derives in the active conduct of an insurance business and income from a qualifying domestic insurance corporation (“QDIC”). The determination of whether a QIC is engaged in the active conduct of an insurance business is based on facts and circumstances and generally requires the officers and employees of the QIC to carry out substantial managerial and operational activities. Unlike the 2015 Proposed Regulations, the 2019 Proposed Regulations allow the QIC to take into account activities of officers and employees of certain related entities, provided that the QIC exercises regular oversight and supervision over the services performed by the related entity’s officers and employees (with no guidance provided on the meaning of “oversight and supervision”) and certain compensation arrangement requirements are satisfied.

The 2019 Proposed Regulations introduced a new concept known as the “active conduct percentage” to function as a proxy for the determination of whether a QIC is engaged in the active conduct of an insurance business, defining the active conduct percentage for a taxable year as (i) the aggregate amount of expenses, including compensation (or reimbursement of compensation) and related expenses, for services of the officers or employees of the QIC and certain related parties incurred by the QIC for the taxable year that are related to the production or acquisition of premiums and investment income on assets held to meet its obligations under insurance, annuity or reinsurance contracts issued or entered into by the QIC, divided by (ii) all such expenses regardless of the service provider. Ceding commissions are not taken into account for purposes of this percentage. Income that a QIC derives in the active conduct of an insurance business is defined by the 2019 Proposed Regulations as an amount equal to the QIC’s passive income—taking into account exceptions other than the Insurance Company Exception earned with respect to assets of a QIC that are available to satisfy liabilities of the QIC related to its insurance business if the “active conduct percentage” for the taxable year is 50 percent or more and

zero if the “active conduct percentage” falls below this 50 percent threshold. Similarly, for purposes of the Asset Test, passive assets will not include (i) assets of a QIC available to satisfy its liabilities related to its insurance business if the “active conduct percentage” of the QIC is at least 50 percent and (ii) assets of a QDIC. This test reflects an attempt by Treasury to provide a bright line test for measuring a QIC’s active conduct, and comments were requested on whether this “all or nothing” test is a good proxy for active conduct or whether it should be a safe harbor alongside a facts and circumstances test.

For purposes of applying the Look-Through Rule, as well as the Look-Through Partnership Rule (described below), an item of income treated as received or accrued or an asset treated as held by the QIC under the Look-Through Rule or the Look-Through Partnership Rule that would be passive at the subsidiary entity level is treated as an item of income or an asset of the QIC for purposes of the Insurance Company Exception. However, such item of income or asset will only be treated as used in the active conduct of an insurance business by a QIC if the AFS used to test the QIC status of the foreign corporation includes the assets and liabilities of the subsidiary entity.

As discussed above, the income and assets of a QDIC would not be treated as passive. A QDIC is a U.S. corporation subject to tax as an insurance company under subchapter L of the IRC and that is subject to federal income tax on its net income. This rule is intended to address situations where a foreign corporation that is determining its status under the PFIC rules owns a domestic insurance company through a structure where the Special Characterization Rules do not apply. However, this rule would not apply for purposes of determining whether a foreign corporation is a PFIC for purposes of the corporate attribution rules that determine indirect ownership of lower-tier PFICs.

The 2019 Proposed Regulations also provide that no item can be counted more than once, including, for example, determining AIL for purposes of the 25% Test and the 10% Test.

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c. Proposed Regulations on General PFIC Issues

As noted above, the 2019 Proposed Regulations provide guidance on issues related to ownership of a PFIC and the application of the Income Test and Asset Test for determining PFIC status. The following discussion briefly describes some of these provisions of the 2019 Proposed Regulations.

i) *Application of the Corporate Attribution Rules*

The 2019 Proposed Regulations would apply a “top down” approach to the ownership attribution rules when a pass-through entity with a U.S. owner(s) holds the stock of a PFIC indirectly through a foreign corporation that is not a PFIC.

ii) *Exempt Income*

For purposes of applying the Income Test, intercompany dividends received by a domestic corporation and treated as received by a foreign corporation being tested for PFIC status under the Look-Through Rule would be taken into account even if such dividends are excluded under the consolidated return rules, subject to rules that eliminate double counting (discussed below).

iii) *Application of Exceptions to FPHCI in the CFC Context*

As discussed above, passive income for purposes of the PFIC rules is defined by reference to the definition of FPHCI under the CFC rules. The 2019 Proposed Regulations provide that only certain of the exceptions to the definition of FPHCI carry over to determine passive income under the PFIC rules, specifically excluding, among other items, the exception for income from an active insurance business (Treasury concluded that the recent statutory changes to the Insurance Company Exception in the 2017 Act and the related tests should govern).

iv) *Income Earned and Assets Held Through Partnerships*

The 2019 Proposed Regulations provide that a foreign corporation’s distributive share of income of a partnership is treated as income received directly by the foreign corporation if it owns, directly or indirectly, at least 25-percent of the value of the partnership (such partnership will be considered a “Look-Through Partnership”), treating income earned through partnerships similarly to income earned through corporate subsidiaries (the “Look-Through Partnership Rule”). Similarly, a foreign corporation with an interest in a Look-Through Partnership would be treated as owning its proportionate share of the partnership assets for purposes of the Asset Test. If the 25-percent ownership threshold is not met, the foreign corporation’s distributive share of the partnership’s income would be treated as passive and the partnership interest would be treated as a passive asset. To qualify for an exception to passive income that is based on activities, the Look-Through Partnership itself generally must be engaged in the relevant activities (which differs from the CFC rules).

v) *Methodology of Applying the Asset Test*

The 2019 Proposed Regulations generally apply quarterly testing (although more frequent measurement periods may be used and special rules are provided for short taxable years). The average percentage of a foreign corporation’s assets is determined using the average of gross values (or adjusted bases) at the end of each measurement period rather than on the basis of passive asset percentage at the end of each measurement period. The 2019 Proposed Regulations also provide rules with respect to dual character assets (part passive/part active).

vi) *Application of the Look-Through Rule*

If a foreign corporation owns directly or indirectly at least 25-percent of the value of the stock of another corporation (such as the corporation referred to as a “Look-Through Subsidiary”), the foreign corporation will be treated as directly holding its proportionate share of the assets and directly receiving its proportionate share of the income of

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the Look-Through Subsidiary for purposes of the Asset Test and Income Test (subject to the Special Characterization Rules described below). The 2019 Proposed Regulations provide that indirect ownership means ownership through entities (whether domestic or foreign) and set forth rules for determining whether the 25-percent ownership test is met for purposes of the Income Test and the Asset Test. Guidance related to the elimination of certain intercompany payments and assets for purposes of the Income Test and the Asset Test in cases where the Look-Through Rule apply are also included in the 2019 Proposed Regulations.

vii) Ownership Between the Look-Through Rule and the Special Characterization Rule

The 2019 Proposed Regulations generally give priority to the Special Characterization Rule when there is potential overlap with the Look-Through Rule, on the theory that the Special Characterization Rule is the more specific rule where a foreign corporation owns (directly or indirectly through a partnership) at least 25-percent by value of a domestic corporation that owns qualified stock of other domestic corporations. However, this overlap rule is subject to certain limitations and antiabuse rules. The 2019 Proposed Regulations also clarify that the accumulated earnings tax need not be actually imposed on the foreign corporation and the foreign corporation need not have U.S. source income for the Special Characterization Rule to apply.

viii) Change of Business

The 2019 Proposed Regulations provide guidance on the exception to PFIC status for foreign corporations that transition from one active business to another.

d. Concluding Observations

The 2019 Proposed Regulations represent a mixed bag for foreign-parented global insurers and reinsurers. Although dispensing with the requirement included in the 2015 Proposed Regulations that core insurance activities (including investment activities) be conducted by officers and employees of the foreign (re)insurer without taking into

account any activities conducted by related parties to satisfy the active conduct test, the 2019 Proposed Regulations introduce the concept of active conduct percentage, which may cause foreign-parented global (re)insurers that outsource investment management, administrative and other functions to be characterized as PFICs even when assuming significant (re)insurance risk and maintaining robust underwriting and management teams. In addition, the exceptions to the application of the QDIC rules and the coordination of the Look-Through Rule and the Special Characterization Rule could produce surprising results for foreign-parented global (re)insurance groups with substantial U.S. operations, such as the treatment of U.S. shareholders of the foreign parent as indirect shareholders of lower-tier PFICs (such as foreign reinsurers that are not QICs) in situations where the foreign parent itself is not a PFIC. The inability to treat passive income or assets owned by a QIC under the Look-Through Rule or Look-Through Partnership Rule as non-passive pursuant to the Insurance Company Exception unless the AFS used to test the QIC status includes the assets and liabilities of the subsidiary entity could also result in unexpected PFIC characterization.

In the insurance-linked securities space, catastrophe bond issuers and in some cases, “pure” sidecars historically have been treated as PFICs. The 2017 Act resulted in PFIC characterization of most sidecars assuming predominantly catastrophe business (whether “pure” or “market facing”) and insurance-linked securities funds that were structured to avoid PFIC characterization through large books of collateralized reinsurance relative to the overall investments, as much of the collateralized reinsurance was not expected to produce adequate reserves under the 25% Test (even though, as noted earlier, such funds were assuming significant insurance risk). The 2019 Proposed Regulations do not appear to change the PFIC characterization in these cases.

The 2019 Proposed Regulations will become effective once finalized, although taxpayers may apply the provisions of the regulations dealing with the Insurance Company Exception to taxable years beginning after December 31, 2017, and all other provisions to all open taxable years as if they were final, provided that the rules are applied

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consistently. Treasury solicited comments on many aspects of the 2019 Proposed Regulations and has met with a number of insurance industry participants.

ii. Base Erosion and Anti-Abuse Tax

On December 2, 2019, Treasury issued final regulations (the “Final Regulations”) and proposed regulations (the “2019 Proposed Regulations”) on the application of the global base erosion and antiabuse tax (the “BEAT”). The Final Regulations were largely consistent with regulations proposed in 2018 (the “2018 Proposed Regulations”) that were discussed in the 2018 Year in Review and are generally effective for taxable years ending on or after December 17, 2018. The 2019 Proposed Regulations will not be effective until issued in final form, at which point they will generally be effective for taxable years beginning after the date that final regulations are published (although taxpayers generally can rely on the 2019 Proposed Regulations pending finalization). This summary briefly discusses issues that are particularly relevant to the insurance and reinsurance sectors.

The BEAT is an additional tax imposed on “applicable taxpayers” in an amount equal to the excess of 10 percent (five percent for one taxable year beginning after December 31, 2017 and 12.5 percent for taxable years beginning after December 31, 2025) of “modified taxable income” for a taxable year over an amount equal to its regular corporate tax liability for that year reduced by certain credits (the “base erosion minimum tax amount”). “Modified taxable income” generally is computed by adding back the “base erosion tax benefit” derived from a “base erosion payment” and “base erosion payment” includes, among other items, any amount paid or accrued by an “applicable taxpayer” to a “foreign related person” that is deductible to the payor and any reinsurance premium paid to a “foreign related person.” An “applicable taxpayer” generally means a corporation with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of at least \$500 million (subject to aggregation rules for certain groups) with a “base erosion percentage” (defined as the aggregate amount of “base erosion tax benefits” for the taxable year divided by the

aggregate amount of deductions for such year) of at least three percent. A foreign person is related to the applicable taxpayer if either (i) it owns 25-percent or more of the taxpayer, (ii) it is related to the taxpayer or any 25-percent owner of the taxpayer under IRC section 267 (related to loss disallowance rules applicable to transactions between related parties) or IRC section 707 (related to transactions between partners and partnerships) or (iii) it is related to the taxpayer under the transfer pricing rules of IRC section 482. The specific inclusion of reinsurance premiums as base erosion payments was likely a response to arguments that reinsurance premiums were not deductible payments otherwise subject to the base erosion minimum tax rules under the insurance accounting rules of Subchapter L of the IRC.

On a positive note, the Final Regulations, unlike the Proposed 2018 Regulations, provide clarity on the treatment of claims payments in the context of inbound cross-border affiliate reinsurance by allowing an exception to the definition of a base erosion payment for claims payments made by a U.S. reinsurer to a non-U.S. affiliate cedent provided the underlying insured or annuitant is not a related party. This exception generally applies to claims payments regardless of whether the payment is a deduction of the U.S. reinsurer, which is the case in the context of a domestic life company, or a reduction in gross income, which is the case in the context of a domestic nonlife company. Any claims payment which is not treated as a base erosion payment under this rule will be excluded from the numerator and the denominator of the base erosion percentage. As outbound claims payments move business into the United States rather than erode the U.S. tax base, this exception makes perfect sense.

However, the Final Regulations adopted the rules set forth in the 2018 Proposed Regulations by treating the gross amount of reinsurance payments from a U.S. cedent to a non-U.S. reinsurer in an outbound affiliate reinsurance transaction as base erosion payments, even if reciprocal payments under the reinsurance contract (e.g., premium payments, ceding commissions, loss payments, expense assurances) are settled on a net basis (such as modified coinsurance transactions).

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The Final Regulations followed the 2018 Proposed Regulations by providing that a base erosion payment does not result from amounts paid or accrued to a foreign related party that are subject to U.S. federal income tax as effectively connected income of the foreign related party. However, Treasury rejected requests for a carve-out to the definition of base erosion payment for payments made to an affiliate CFC or PFIC that would be included in income of a U.S. person under applicable U.S. antiferral regimes, even though such payments generally do not erode the U.S. tax base.

The 2019 Proposed Regulations provide an election by which a taxpayer may forgo deductions of payments that would otherwise be considered base erosion payments for all U.S. federal tax purposes to remain outside of the BEAT. The election is an annual election that allows a taxpayer that would otherwise equal or exceed the three percent base erosion percentage threshold to waive allowable deductions on an item-by-item basis to avoid the “cliff effect” of the BEAT. It has been brought to Treasury’s attention that the proposed election might result in disparate treatment for domestic life and nonlife companies.

B. International and U.K. Tax Developments

i. OECD Pillar One and Pillar Two Proposals for Further Reform of the International Tax Framework

On May 31, 2019, the Organization for Economic Cooperation and Development (“OECD”) published a “Programme of Work” designed to develop an international consensus solution to the tax challenges created by an increasingly digitalized economy (the “Programme”). The work follows from the identification, pursuant to Action 1 of the OECD Base Erosion and Profit Shifting (“BEPS”) project, of particular features frequently seen in highly digitalized business models, namely scale without mass, heavy reliance on intangible assets and the importance of data, user participation and their synergies with intangible assets. The Programme grouped the various ideas under consideration into two pillars.

Pillar One focuses on profit allocation and nexus. Pillar Two addresses the remaining BEPS risk of profit shifting to

entities in low tax jurisdictions and seeks to develop rules that would provide jurisdictions with a right to “tax back” where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation, by introducing a globally agreed minimum level of tax for all internationally operating businesses.

The proposals are legally and technically complex and represent a significant departure from the current international tax framework.

ii. Pillar One

The OECD Secretariat Proposal for a “Unified Approach” under Pillar One, published on October 9, 2019, synthesizes various ideas to put forward for discussion a suggested new taxing right and a method for allocating group profits among taxing jurisdictions based on a market concept in addition to the historical “permanent establishment” concept. The effect is to give more taxing rights to the jurisdiction of the customer or user, so as to ensure greater taxation in jurisdictions in which significant business is conducted remotely, without a physical presence.

The proposal is for a new nexus rule (to be implemented through a free-standing provision in double tax treaties), based primarily on sales in the jurisdiction, regardless of any physical presence (such as an in-country marketing or distribution presence). In other words, online sales as well as sales via both unrelated and related local distributors would be caught.

Allocation of profit to the market jurisdiction would consist of up to three components: Amounts A, B and C.

Amount A will represent a share of deemed residual profit, this being the profit remaining after the allocation of routine profits to countries where activities are performed. It is then necessary to determine the split of those non-routine profits between the portion that is attributable to the market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk (which are not targeted by the new taxing right). The example is

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given of a social media business, which may generate non-routine profits from its customers' data (falling squarely within the target of the proposed new taxing right) and also from its innovative algorithms and software (not intended to be caught by the new nexus rule). The level of non-routine profit and what proportion should go to market jurisdictions could be determined using a formula, using a fixed percentage varying by industry. The relevant portion might then be allocated between multiple market jurisdictions using a formulaic approach based on sales.

Amounts B and C are only relevant if the business has a traditional nexus (subsidiary or permanent establishment) in the market jurisdiction. Amount B will represent a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; this change would simplify and displace traditional transfer pricing rules for rewarding such activities. Amount C will represent a potential additional allocation to the market jurisdiction where, based on traditional transfer pricing rules, in-country functions exceed the baseline activity compensated by Amount B.

The Unified Approach is said to be focused primarily but not exclusively on "consumer-facing businesses." It is acknowledged that this approach suggests that some sectors should be carved out, such as extractive industries and commodities. There may also be a size threshold of €750 million annual revenue, possibly adjusted in line with the size of a given market.

The OECD Secretariat notes that further discussion should take place to consider whether other sectors, such as financial services, should also be carved out, taking into account the tax policy rationale as well as other practicalities.

It is difficult to respond definitively to this observation because the underlying tax policy rationale is not altogether clear. Participants in the consultation have remarked that it is not clear why a business which markets business to business is fundamentally different from a business which operates business to consumer. Nor are all consumer-facing businesses high-margin business nor do they

always generate "above normal" profits. Furthermore, boundary-issue complications will arise if supplies through intermediaries, supplies of component products and franchise arrangements are within scope.

Having said that, the insurance industry (including via submissions by various industry representative bodies) has used the consultation process to argue that the perceived deficiencies in the current international tax framework, which the "Unified Approach" is intended to remedy, are not present in any way in relation to the insurance industry. In support of this argument, the insurance industry cites the digital services tax, which various countries are introducing as an interim measure ahead of any international consensus approach under Pillar One, and which is not expected to affect the sector generally. Accordingly, the industry is taking the position that it should be expressly excluded from the scope of the Pillar One proposals, for the following reasons:

- (1) (Re)insurance is not a highly digitalized business model;
- (2) The regulatory capital rules applicable to (re)insurers are designed to ensure that the company bearing the risk of the loss has local capital available to meet local losses;
- (3) Insurance companies have substance in the jurisdictions in which they operate: capital is held in those companies and the appropriate number of people are employed. While different business models need different numbers of people, insurance always requires highly qualified employees to assume and manage risk; insurance companies do not usually participate in the economic life of a jurisdiction without an associated or meaningful local presence;
- (4) Pillar One intends to target businesses with regular and predictable profits or super-profits arising from marketing intangibles. However, profits in the (re)insurance sector do not come from intangibles and are volatile as they can be affected

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by unexpected man-made and natural disasters; if within scope, a portion of such unpredictable and potentially significant losses would also have to be allocated, presumably, to the market jurisdiction;

- (5) Although insurance groups are often multinational, and reinsurance groups are always multinational, the business model is usually based on companies with a local physical, and hence taxable, presence, as insurance companies need to be close to their customers. As such, taxing rights are already largely with the jurisdiction of the consumer;
- (6) The purchase of insurance is already subject to indirect taxes in many jurisdictions based on the location of the risk (typically, the location of the user); and
- (7) The current arm's-length principle system allocates taxing rights for insurance business to the appropriate jurisdiction. Insurance already has detailed guidance under Part IV of the OECD's report on the attribution of profits to permanent establishments: e.g., investment return on assets is already allocated to the location where the insurance company has the insurance risk. Insurers do not have misaligned non-routine profits.

iii. Pillar Two

The OECD published its consultation document on the *Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two* on November 8, 2019 (the "GloBE Consultation Document"). This proposal aims to ensure that multinationals pay a minimum amount of tax regardless of how they organize their business geographically, by introducing a global minimum tax and/or a proposed tax on base eroding payments, which would operate through a denial of a deduction or the imposition of source-based taxation (including withholding tax) on certain payments. The document solicits comments on various technical implementation issues.

Although much of the impetus for the work came from concerns as to the treatment of highly digitalized businesses,

recognizing that it is virtually impossible to ring-fence the digital economy from the rest of the economy for tax purposes, the proposal is that all internationally operating businesses should be subject to the enhanced anti-profit shifting rules.

The Programme envisages that GloBE will operate as a top-up tax to an agreed fixed minimum tax rate. The examples set out in the Programme use a rate of 15 percent, but this is stated to be for purely illustrative purposes and, at present, there is no consensus on what the rate should be. The minimum rate will have a significant effect on the ambit of the rules and on further policy decisions around whether carve-outs are necessary.

The more recent GloBE Consultation Document concentrates on three design aspects for computing the effective tax rate of a multi-national enterprise ("MNE") and applying a minimum tax rate:

- (1) the starting point for the tax base determination; the consultation document favors using the financial statement rules under the accounting standard applicable to the ultimate parent, on the grounds that it would reduce re-computation costs (at least for groups that are already preparing consolidated financial statements) and would reduce the discrepancies between MNEs compared with a system where the local or parent tax base was the starting point (although it might still be possible to arbitrage differences between parent accounting standards);
- (2) the level of blending of (high- and low-taxed) income from different sources that is permitted in order to calculate the effective rate of tax borne by an MNE; the document considers worldwide, jurisdictional and entity level blending; and
- (3) carve-outs and thresholds.

The Programme proposed for discussion some potential Pillar Two mechanisms regarding cross-border payments, in the form of two principal and two supplementary rules, namely:

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- (1) an income inclusion rule, which would tax the income of a foreign branch or subsidiary if that income was subject to an effective tax rate that is below a minimum rate;
- (2) an undertaxed payments rule; this would protect the tax base of the source country by denying a deduction for the payor or impose source-based taxation (including withholding tax) for certain payments to a related party unless the recipient was subject to tax on the payment at or above a minimum rate;
- (3) a switch-over rule for tax treaties (“switching off” the exemption method for double taxation in respect of the profits attributable to a foreign permanent establishment, in favour of the credit method); this measure can be viewed as building on the income inclusion rule; and
- (4) a subject-to-tax rule, complementing the undertaxed payments rule, whereby treaty benefits would be denied unless the income was subject to tax at or above a minimum rate.

However, the GloBE Consultation Document published later in 2019 merely references these rules without elaborating on their detail or role. It is unclear how they interact with the rest of the Pillar Two proposals; and, in particular, whether the undertaxed payments rule is an alternative/supplementary/additional method of enforcing a minimum tax rate or whether it is really a freestanding tool which countries can employ to achieve the separate objective of protecting their tax base (echoing the U.S. BEAT). Nor is the interaction and order of priority of application as between these four rules explored.

There are obvious overlaps with many CFC regimes and, more specifically, the U.S. global intangible low-tax income (“GILTI”) regime. As a result, commentators have suggested that a new minimum tax rate regime should include carve-outs for countries which already operate an acceptable substitute anti-avoidance regime.

In addition, general feedback from the consultation, especially in relation to the four cross-border payment rules, has been that the mischief targeted by these ideas is already largely addressed by the ability of countries to impose withholding taxes on dividends, interest, royalties and other outbound payments (subject only to their bilateral treaty networks), together with the BEPS fixed ratio restrictions on the deductibility of interest payments, the hybrid mismatch rules, the harmful tax practices recommendations (which led to the European Union economic substance rules) and the new condition imposed on treaty exemption from withholding tax being introduced via the BEPS Multilateral Instrument (principal purpose test or limitation on benefits provision). The suggestion is that Pillar Two is premature and that it would be better to see how effective these measures are in dealing with the problem (and perhaps seek to bolster those measures) instead of introducing a completely new and complex regime.

Even jurisdictions with highly developed anti-avoidance legislation like the U.K. will have to cope with considerable upheaval if the Pillar proposals are implemented. For example, if an “acceptable” CFC regime must pick up the profits of all low-taxed subsidiaries, several of the existing “escape routes” from the U.K. CFC regime, based on local “substance,” would have to be blocked. For the U.S., the question is whether the GILTI and BEAT measures introduced by the Tax Cuts and Jobs Act of 2017 can be regarded as satisfying GloBE requirements.

As currently formulated, the Pillar Two proposals could have a significant impact on MNEs in the insurance sector.

For the purposes of computing any minimum tax rate top-up tax liability, worldwide blending would potentially be more favorable for groups with a mix of subsidiaries in low tax jurisdictions (e.g., Bermuda) and high-tax jurisdictions (such as the U.S., the U.K. or other European countries), although the GloBE Consultation Document sees this approach as less effective in creating a floor for tax competition. Another potentially problematic feature for the insurance industry in terms of the tax base is that local tax liabilities are often based on regulatory returns

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that may demand higher levels of technical provisioning. The exposure of much of the insurance industry to long-term timing differences would also prove challenging in determining the effective tax rate in practice. A particular example of this would be designing a method for computing the effective tax rate of an MNE which includes one or more corporate members of Lloyd's, which are taxed on a three-year deferred basis, as and when profits of an underwriting year of account are "declared."

In addition, the four proposed cross-border payment rules may adversely affect insurance groups with members established in countries like Bermuda or Guernsey, by denying deductions for payments to local companies by affiliates (and, potentially, by unrelated parties too, if the "subject to tax" rule extends the undertaxed payments rule) or imposing withholding tax on such payments.

iv. Next Steps

The OECD held public consultations on the Pillars at the end of 2019 with the stated aim of agreeing on the reforms by the end of 2020, such that the new principles can be incorporated into local tax laws and double tax treaties shortly thereafter.

This timetable looks to be very ambitious. The proposals are still relatively immature, with many policy questions, let alone key design features, still unresolved. The sense of urgency is understandable; the OECD/G20 Inclusive Framework on BEPS would like to head off unilateral action by multiple individual tax jurisdictions (such as the proliferation of digital services taxes already being introduced), but at the moment the proposals are not clearly focused or refined and significant areas have hardly been touched at all—concerning the interaction of the two Pillars, double taxation risks, administrative complexity (for both tax authorities and taxpayers), and dispute resolution mechanisms.

A strong argument can be made in favor of an evaluation of the impact of the current BEPS measures that are being implemented, in order to assess what truly remains to be addressed after all the BEPS actions are finalized. In addition, an impact assessment of the combined effects on taxpayer behavior of Pillar One and Pillar Two should be undertaken.

IX. GLOSSARY

- “2017 Act” means the U.S. Tax Cuts and Jobs Act of 2017.
- “€STR” means the euro short-term rate.
- “AFS” means applicable financial statement.
- “AG 33” means the NAIC Actuarial Guideline 33.
- “AG 48” means the NAIC Actuarial Guideline 48.
- “AIL” means applicable insurance liabilities.
- “BEAT” means the U.S. Base Erosion and Anti-Abuse Tax.
- “BEPS” means base erosion and profit shifting.
- “Brexit” means the U.K. decision to and procedure to withdraw from the European Union.
- “CFC” means a controlled foreign corporation under U.S. tax law.
- “CMA” means the U.K. Competition and Markets Authority.
- “ComFrame” means the Common Framework for the Supervision of IAIGs adopted by the IAIS in November 2019.
- “Covered Agreement” means the U.S./E.U. Covered Agreement, signed in 2017 and effective in September 2022.
- “ECB” means the European Central Bank.
- “Eligible Reinsurer” means qualifying U.S. reinsurers domiciled in NAIC accredited states, and qualifying non-U.S. reinsurers domiciled in a Qualified Jurisdiction Reciprocal Jurisdiction.
- “EMMI” means the European Money Markets Institute.
- “EONIA” means the Euro OverNight Index Average.
- “ESMA” means the European Securities and Markets Authority.
- “E.U.” means the European Union.
- “EUWA” means the European Union (Withdrawal) Act 2018 of the U.K.
- “FCA” means the Financial Conduct Authority (U.K.).
- “FPHCI” means foreign personal holding company.
- “Framework” means the Holistic Framework for Systemic Risk in the Insurance Section adopted by the IAIS in November 2019.
- “FSB” means Financial Stability Board.
- “FSOC” means Financial Stability Oversight Council.
- “FTSE” means the Financial Times Stock Exchange.
- “GAAP” means U.S. generally accepted accounting principles.
- “GCC” means group capital calculation.
- “GILTI” means the U.S. global intangible low-tax income regime.
- “GloBE” means the Global Anti-Base Erosion Proposal of the OECD.
- “G-SIIs” means Global Systematically Important Insurers.
- “IA” means the Investment Association.
- “IAIG” means internally active insurance group.
- “IAIS” means International Association of Insurance Supervisors.
- “ICMA” means the International Capital Market Association.
- “ICS” means insurance capital standards.

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- “IFRS” means international financial accounting standards.
- “ILS” means insurance-linked securities.
- “IMF” means the International Monetary Fund.
- “IRC” means the Internal Revenue Code of the United States.
- “IRS” means the U.S. Internal Revenue Service.
- “ISPV” means insurance special purpose vehicles.
- “IVIS” means the Institutional Voting Information Service.
- “LPS” means limited-purpose subsidiaries.
- “LTC” means long-term care insurance
- “MISPV” means multi-arrangement insurance special purpose vehicles.
- “MNE” means multinational enterprise.
- “MPI” means the Macro-Prudential Initiative of the NAIC.
- “NAIC” means National Association of Insurance Commissioners.
- “OECD” means the Organization for Economic Cooperation and Development.
- “PCR” means prudential capital requirement.
- “PFIC” means a passive foreign investment company under U.S. tax law.
- “PIC” means Pension Insurance Corporation.
- “PRA” means the Prudential Regulation Authority
- “Prospectus Regulation” means the governing European securities prospectus regime.
- “QIC” means qualifying insurance corporation.
- “Qualified Jurisdiction” means a U.S. or non-U.S. jurisdiction that has been approved by the NAIC pursuant to the *NAIC Process for Evaluating Qualified and Reciprocal Jurisdictions* and appears on the NAIC List of Qualified Jurisdictions.
- “Qualified Jurisdiction Reciprocal Jurisdiction” means a Qualified Jurisdiction that is included in the NAIC list of Reciprocal Jurisdictions having met additional qualifications required under the Covered Agreement, including the elimination of reinsurance collateral and local presence requirements for U.S. reinsurers in that jurisdiction.
- “RBC” means Risk-Based Capital.
- “S&P” means the rating agency Standard & Poor’s.
- “SCR” means Solvency Capital Requirement.
- “SEC” means the U.S. Securities and Exchange Commission.
- “SIFI” means systematically important financial institution.
- “SM&CR” means the Senior Managers and Certification Regime of the U.K.
- “Solvency II” means the European Union’s Solvency II Directive (Directive 2009/138/EC), which went into effect on January 1, 2016.
- “Treasury” means the U.S. Treasury Department and the IRS.

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NAIC Amended Credit for Reinsurance Law and Regulation

Credit for Reinsurance Standards from Zero to 100%

The attached charts illustrate the credit for reinsurance standards set forth in the NAIC Credit for Reinsurance Model Law and Regulation as amended on June 25, 2019. Several terms used in the charts are defined below. Individual state laws and regulations may vary from the NAIC models and therefore should be consulted.

“Accredited Reinsurer” means an insurer licensed in a U.S. jurisdiction that submits to the jurisdiction of the U.S. cedent’s domestic state, allows such state to examine its books and records and maintains a policyholder surplus of \$20 million.

“Certified Reinsurer” means a U.S. or a non-U.S. reinsurer domiciled in a Qualified Jurisdiction that satisfies certain financial and rating standards set forth in the NAIC Credit for Reinsurance Model Law and Regulation pursuant to the November 6, 2011 amendments.

“Covered Agreement” means the Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance signed on September 22, 2017.

“Date of Reinsurer Certification” means the date on which a reinsurer domiciled in a Qualified Jurisdiction has satisfied the requirements for reinsurance collateral reduction and becomes a Certified Reinsurer.

“Date of Reinsurer Eligibility” means the date on which a reinsurer domiciled in a Reciprocal Jurisdiction has satisfied the requirements for reinsurance collateral elimination under the NAIC Amended Credit for Reinsurance Law and Regulation.

“Eligible Reinsurer” means a U.S. or a non-U.S. reinsurer domiciled in a Reciprocal Jurisdiction that has satisfied certain financial and commercial standards established by the NAIC Amended Credit for Reinsurance Law and Regulation.

“NAIC Amended Credit for Reinsurance Law and Regulation” means the NAIC Credit for Reinsurance Model Law (#785) and Model Regulation (#786) as amended on June 25, 2019.

“Qualified Jurisdiction” means a U.S. or a non-U.S. jurisdiction that has been approved by the NAIC pursuant to the NAIC *Process for Evaluating Qualified and Reciprocal Jurisdictions* and appears on the NAIC List of Qualified Jurisdictions. As of January 1, 2020, the Non-U.S. Qualified Jurisdictions were Bermuda, France, Germany, Ireland, Japan, Switzerland and the United Kingdom.

“Reciprocal Jurisdiction” means a U.S. or a non-U.S. jurisdiction appearing on the NAIC List of Reciprocal Jurisdictions having met the requirements set forth in the NAIC Amended Credit for Reinsurance Law and Regulation for one of the following classes of Reciprocal Jurisdictions:

- “Covered Agreement Reciprocal Jurisdiction” - a non-U.S. Jurisdiction that is party to an in-force covered agreement with the U.S. is automatically a Reciprocal Jurisdiction.
- “Qualified Jurisdiction Reciprocal Jurisdiction” - a Qualified Jurisdiction in good standing may be reviewed for inclusion on the NAIC List of Reciprocal Jurisdictions provided it meets additional qualifications, including the elimination of reinsurance collateral and local presence requirements for U.S. reinsurers as required under the Covered Agreement. As of January 1, 2020, the Qualified Jurisdiction Reciprocal Jurisdictions were Bermuda, Japan and Switzerland.
- “U.S. Reciprocal Jurisdiction” - a U.S. NAIC Accredited Jurisdiction shall automatically be recognized as a Reciprocal Jurisdiction.

“U.S. NAIC Accredited Jurisdiction” means a U.S. jurisdiction that meets the requirements for accreditation under the NAIC financial standards and accreditation program. As of April 2019, all 50 U.S. states, the District of Columbia and Puerto Rico were U.S. NAIC Accredited Jurisdictions.

NAIC Amended Credit for Reinsurance Law and Regulation

Credit for Reinsurance Standards from Zero to 100%

Zero Reinsurance Collateral for Eligible Reinsurers in Reciprocal Jurisdictions

If the Reinsurer Is Domiciled in:

A Covered Agreement
Reciprocal Jurisdiction

or

A Qualified Jurisdiction
Reciprocal Jurisdiction

or

A U.S. Reciprocal
Jurisdiction

and

The Reinsurer is an Eligible Reinsurer in the Cedent's Domestic State

then

No collateral is required for the following Reinsurance Agreements, Losses Incurred and Reserves Reported by the Cedent:

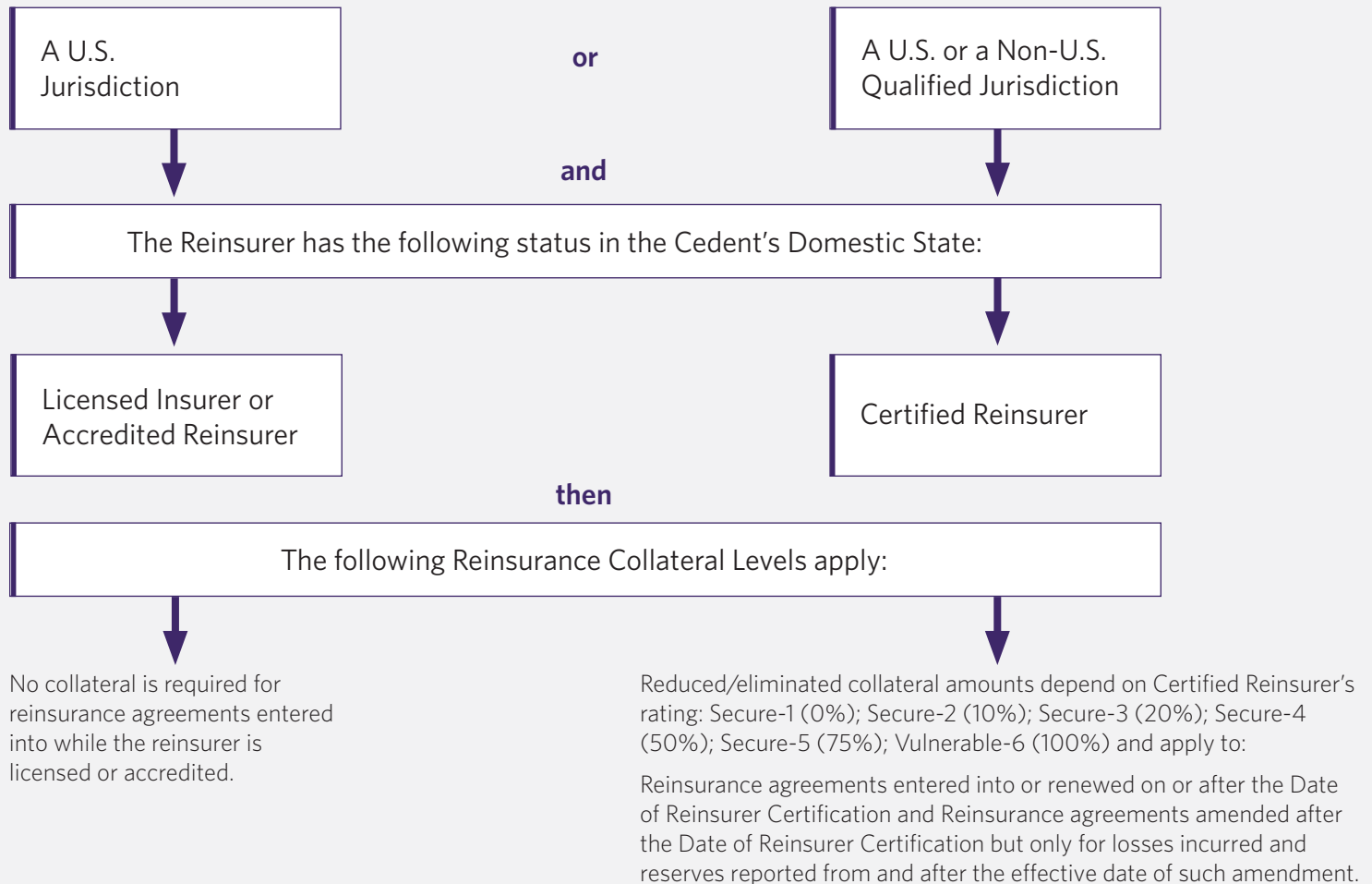
- Reinsurance agreements entered into, amended or renewed on or after the effective date of the NAIC Amended Credit for Reinsurance Law and Regulation as enacted by the state
 - But only with respect to losses incurred and reserves reported on or after the Date of Reinsurer Eligibility or the effective date of the reinsurance agreement, amendment or renewal, whichever is later.

NAIC Amended Credit for Reinsurance Law and Regulation

Credit for Reinsurance Standards from Zero to 100%

Reduced and Other Zero Collateral Provisions

If the Reinsurer Is Domiciled in:



NAIC Amended Credit for Reinsurance Law and Regulation

Credit for Reinsurance Standards from Zero to 100%

100% Collateral Requirements

If the Reinsurer Is Domiciled in:

