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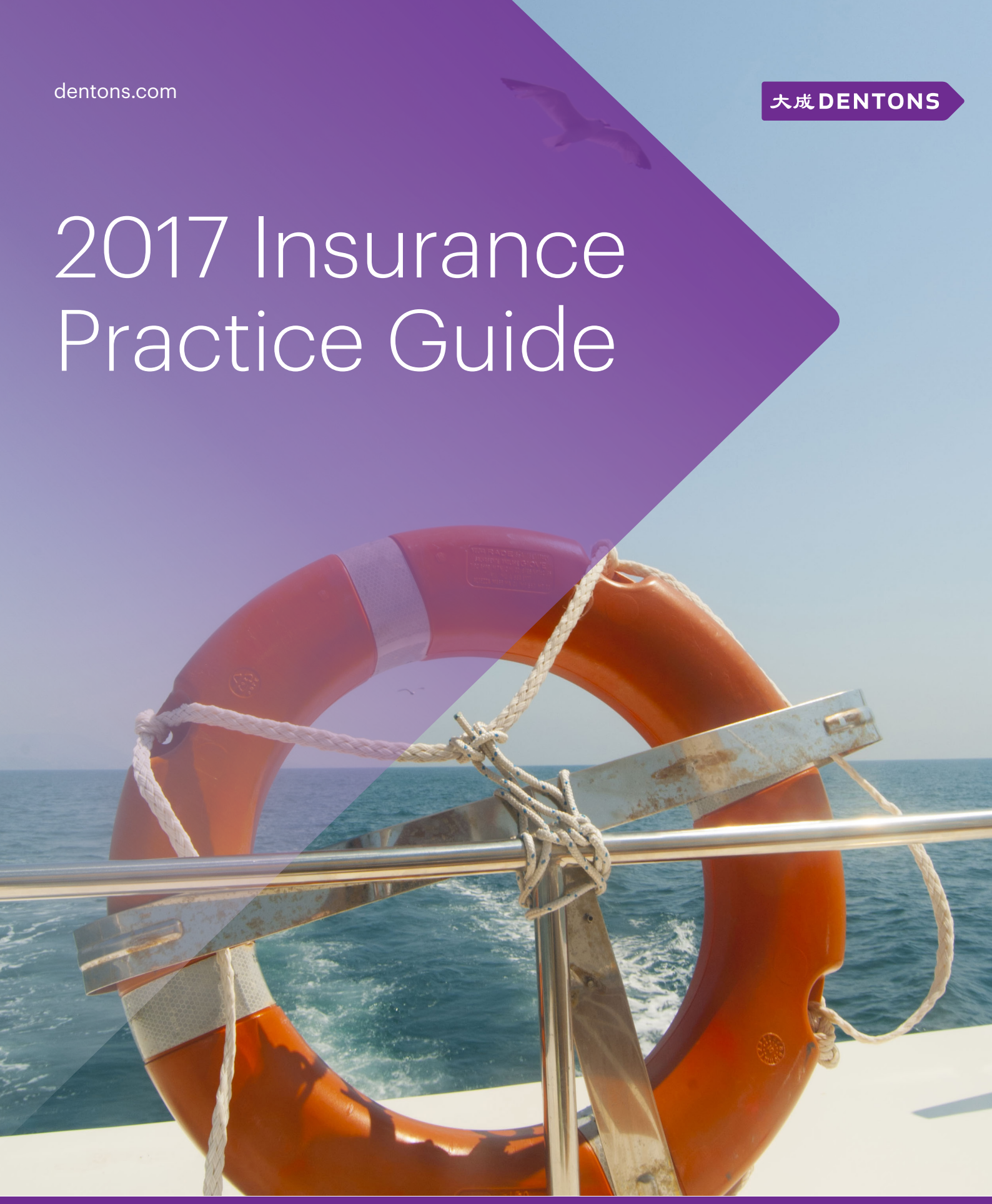
# 2017 Insurance Practice Guide



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## 1. Regulation

### 1.1 Regulation of insurers and reinsurers

#### Historical background

The insurance regulatory framework in the United States has a rich history that dates back to the 19th century. In the 1869 *Paul v. Virginia* case, the Supreme Court held that "issuing a policy of insurance is not a transaction of commerce" and, as such, regulating and taxing the insurance business is a state responsibility. The states immediately began brainstorming regulatory approaches, which led to the 1871 formation of the National Insurance Convention, now known as the National Association of Insurance Commissioners (NAIC).

#### The NAIC

The NAIC is the US standard-setting and regulatory support organisation, created and governed by the 56 chief insurance regulators from the states, the District of Columbia and five US territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review and co-ordinate their regulatory oversight. Regulators also draft and consider model laws and regulations in the individual jurisdictions via a public involvement process. NAIC staff support these efforts and represent the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the US national system of state-based insurance regulation.

#### State regulators

State insurance regulators' responsibilities have grown in scope and complexity as the industry has evolved over the past 150 years. The *Paul v. Virginia* decision was overturned in another Supreme Court case, *United States v. Southeastern Underwriters*, in which the Supreme Court held that insurance was, indeed, commerce. The resulting market disruption and apparent regulatory void led Congress to enact the McCarran-Ferguson Act in 1945, which clarified that the states should continue to regulate and tax the business of insurance, and affirmed that the states' continued regulation of the industry was in the public's best interest.

The general rule is that the states are responsible for the regulation of insurance unless the federal government duly enacts legislation specifically pre-empting some aspect of the states' authority. An example of this federal pre-emption at work was the Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLB), which created a comprehensive regulatory framework to permit affiliations among banks, securities firms and insurance companies. By declaring that the McCarran-Ferguson Act remained in effect, GLB once again affirmed that states should regulate the business of insurance, but Congress also called for state reforms that would allow insurance companies to compete more effectively in a newly integrated financial service marketplace, and respond with greater innovation and flexibility to consumers' evermore demanding needs. GLB also established the concept of functional regulation (ie, where each functional regulator is responsible for regulation of its functional area).

It is the state legislatures that establish and set broad policy for the regulation of insurance by enacting legislation providing the regulatory framework under which the regulators will operate. They establish laws, often based on model laws prepared through the NAIC, that grant authority to state regulators and contain mechanisms for overseeing state insurance departments. State legislatures also approve regulatory budgets. State insurance departments employ 11,209 regulators to implement state-based legislation (2016 figures).

Increases in staff and advancements in technology have allowed regulators to substantially improve the quality and effectiveness of their financial oversight of insurers, and to expand their consumer protection activities. Additionally,

state regulation of insurance has become a major source of revenue for the states, primarily through state premium taxes.

## Regulation of the insurance industry

The fundamental reason for government regulation of insurance is to protect American consumers. Insurance is more heavily regulated than other types of business because of the complexity of insurance contracts, because of the lack of sufficient information for insurance consumers to adequately shop, price and judge the adequacy of coverage, and because insurance contracts are generally viewed as contracts of adhesion. Conceptually, insurance regulation is very simple, focusing most heavily on monitoring the financial health of insurers to ensure that companies will be able to pay claims when they come due, and compliance/conduct of insurers and all other licensees to ensure that policyholders are treated fairly. Put another way, all regulatory functions fall under either solvency regulation (ie, sustaining the solvency of insurers so they are financially able to make good on the promises they have made) or market regulation (ie, creating a framework where policyholders and claimants are treated fairly).

State insurance regulatory systems are generally accessible and accountable to the public, and sensitive to local social and economic conditions. State regulation has proven effective at protecting consumers and ensuring that promises made are kept. Insurance regulation is structured around several key functions, including insurer licensing, producer licensing, product regulation, market conduct, financial regulation and consumer services. Through NAIC peer review and accreditation, financial regulation is "substantially similar" among the states, in order to diminish any perceived regulatory arbitrage.

Broadly speaking, market regulation consists of analysis and oversight of insurers' behaviour and conduct in the market, including the treatment of policyholders and claimants in product development and pricing, competition, statistical reporting, the administration of residual markets, the licensing of insurance producers, and consumer assistance and information services. Market regulators employ a variety of oversight techniques, from analysis conducted within the agency to on-site examinations.

## 1.2 Domestic developments and impact of standards

### Domestic developments in the regulation of insurance

The Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) further impacted state insurance regulation. Dodd-Frank is primarily banking and securities reform legislation, but also created the Federal Insurance Office (FIO) to gather information to inform Congress and the federal government on insurance matters. It also included some reinsurance reform and changed the basis for regulating and taxing surplus lines insurers. The Act also created unique standby authority to enable FIO and the United States Trade Representative (USTR) to address, if necessary, specific areas where US (ie, state) insurance regulation treats non-US insurers differently than US insurers through a "covered agreement." Under certain circumstances, covered agreements can serve as a basis for pre-emption of state law, but only if the agreement relates to measures substantially equivalent to the protections afforded consumers under state law.

Dodd-Frank also gave the Federal Reserve regulatory responsibilities for insurance holding companies that own federally insured banks or thrifts, and for insurance companies designated as systemically important by the US Financial Stability Oversight Council (FSOC). These responsibilities do not replace the state insurance regulatory functions but are an additional layer of oversight for these specific entities.

### International co-operation

Working through the NAIC, state regulators were instrumental in the formation of the International Association of Insurance Supervisors (IAIS) in 1994, and remain very active in the association. The IAIS is the principal international organisation of insurance supervisors, representing insurance regulators and supervisors in more than 200 jurisdictions in over 140 counties that collectively account for 97% of the world's insurance premiums. The IAIS is engaged in the creation of international standards for insurance supervision, and works to promote effective and globally consistent supervision of the sector while contributing to global financial stability. Importantly, the IAIS has no regulatory or legal authority; its role is to inform members, including in the US, of the latest developments in international regulation. Collectively, state insurance regulators, NAIC staff, the federal insurance office staff and representatives from the Federal Reserve constitute "Team USA," contributing to (and benefiting from) the work of the IAIS.

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In closing, the primary state insurance regulatory functions remain virtually unchanged, as they have been since the enactment of McCarran-Ferguson, allowing state regulators to oversee the solvency of US sector players and to regulate their behaviour in the US marketplace.

# 2. Distribution

## 2.1 Insurance and reinsurance products

### Parties to insurance transactions

In the US, there are three principal parties to most insurance transactions: an insurer, an insurance producer and an insured. The insurer is the company that underwrites and issues the insurance policy and assumes the subject risk. The insurance producer is the party that offers the insurer's products for sale. The insured (or policyholder) is the party to which the insurance policy is issued, in exchange for the payment of a premium.

### 'Agent' vs. 'Broker'

Historically, the term insurance "agent" was defined as a person appointed by an insurer, as its representative, to sell insurance on its behalf. The term insurance "broker" historically referred to a representative of the insured in the placing of insurance with insurers in return for a commission from either the insurer or an agent of the insurer. In the US, the line between "agent" and "broker" has blurred over time. Following the widespread adoption of the NAIC's Model Producer Licensing Act of 2000 (MPLA), most states now use the catch-all term "producer" to describe both agents and brokers. A minority of states, however, have not adopted the MPLA in its entirety, or not adopted its uniform terms.

### Licensing requirements

Every state has enacted laws and regulations applicable to the licensing of individual and business-entity insurance producers, whether or not the producer is a resident of that particular state. These laws are the same as, or substantially similar to, the MPLA. Under the MPLA, a person may not sell, solicit or negotiate insurance unless that person is licensed as an insurance producer for that line of business in the state. The MPLA defines the terms "sell," "solicit" and "negotiate" as follows:

- "Sell": to exchange a contract of insurance by any means, for money or its equivalent, on behalf of an insurance company.
- "Solicit": to attempt to sell insurance or to urge a person to apply for a particular kind of insurance from a particular company.

- "Negotiate": to confer directly with or to offer advice to a purchaser or prospective purchaser of a particular contract of insurance concerning any of the substantive benefits, terms or conditions of the contract, provided that the person engaged in that act either sells insurance or obtains insurance from insurers for purchasers (MPLA §§ 2(K), (M) and (N)).

GLB significantly modernised the regulation of the distribution of insurance products and producer licensing. Prior to GLB, every state had enacted its own laws and regulations applicable to the licensing of resident and non-resident individual and business entity producers. To avoid federal regulation of producer licensing, GLB required (at least a majority of) states to enact uniform producer licensing or reciprocity provisions. In response to GLB, all states have enacted a statute the same as or similar to the MPLA. In summary, GLB forced states to adopt more uniform methods of licensing insurance producers. Specifically, it requires states to license non-resident producers on the same basis as they are licensed in their home state.

### Exemptions from producer licensing requirements

All states provide exemptions from producer licensing requirements for certain individuals and entities. Such exemptions generally exist for individuals performing strictly "clerical," "administrative" or "ministerial" acts. For example, it is generally acceptable for unlicensed personnel to have conversations with insureds or prospective insureds for purposes of receiving information to transmit to a licensed producer. However, such conversations must be strictly limited to gathering information for transmittal to a licensed producer, and may not include activities that would trigger "phone solicitation" licensing requirements. This means that unlicensed personnel may not accept applications, bind coverage, process requests for insurance, disseminate rates or discuss insurance coverage with insureds or prospective insureds. Overall, contact with customers by unlicensed personnel should be highly limited and/or scripted.

### Commission splitting

In addition to licensing requirements applicable to any party that engages in the sale, solicitation or negotiation of insurance, all states prohibit the payment of commissions or other valuable consideration to unlicensed persons or entities for either transacting insurance or providing services for which a producer licence is required. The prohibition against earning a commission is tied to the fact that most states have enacted general prohibitions against the payment of commissions or other valuable consideration to unlicensed persons or entities for transacting insurance. Specifically, states do not generally allow an unlicensed person to collect a commission (or other compensation) from insurers or other producers for the sale, solicitation or negotiation of insurance products. In other words, licensed parties are not allowed to "split" their commissions with unlicensed parties.

### Distribution of insurance products by non -industry players

In the US, there has been a significant increase in the number of non-industry players (ie, companies whose primary industry is not insurance) expanding their operations to include the distribution of insurance and "insurance like" products. Navigating the sector's complex regulatory environment and, in particular, insurance producer licensing requirements is sometimes difficult for companies that do not regularly deal with state insurance regulation and departments of insurance.

Non-industry players range from wireless communications service providers, transportation carriers, self-storage companies and manufacturers to brick-and-mortar retailers, web-based sellers and shared commerce platforms. More and more, companies are offering warranty, service contract and insurance products to consumers or other third parties. Many have developed enhanced products that blend warranty, service contract and insurance features, bundling such products with commercial insurance policies as necessary to satisfy the patchwork of regulatory standards in the United States and abroad. As a result, it has become more common for non-industry players to have a licensed producer entity within their corporate structure.

## 3. Overseas firms doing business

### 3.1 Overseas-based insurers and reinsurers

Strictly speaking, there is no "US" insurance law because insurance companies doing business in the United States are subject to the laws and regulation of the 56 jurisdictions that rule their respective roosts. Generally, to do business on a nationwide basis in the US, an insurer or insurance intermediary must obtain a licence from each state's insurance commissioner. Licensing is required for any solicitation, negotiation, sale or servicing of insurance policies. The state-by-state licensing process can be onerous for US and overseas insurers alike. There are no particular restrictions on overseas insurers entering the US market, but there is also no recognised equivalence with other, non-US jurisdictions, and there are no passporting regimes in place.

There are several exceptions to the state-based licensing requirements that certain types of overseas carriers use to access the US market.

### Reinsurers

Overseas reinsurers can generally provide coverage to US insurers without obtaining a state insurance licence (or otherwise becoming "authorised"). However, US state insurance regulators restrict the amount of financial statement credit the US insurer can take for reinsurance provided by an unauthorised reinsurer, generally requiring the unauthorised reinsurer to provide collateral equal to 100% of the expected gross liabilities under the contract. The collateral requirements are set exclusively by the insurance commissioner in the ceding insurer's domiciliary state. The NAIC has adopted a model law to provide relief from these collateral requirements for reinsurers that become "certified" in the state of domicile of the ceding insurer. Reinsurers domiciled in countries that are deemed to have a strong prudential supervision regime can become certified by demonstrating financial strength and reliability, based on credit ratings and other criteria. More than half of the US states have adopted a version of the NAIC-certified reinsurer model law, and all states are required to do so by 2019 or they will lose their NAIC accreditation. The credit for reinsurance regulatory regime will liberalise further for European reinsurers if the United States and the European Union finalise their "covered agreement", discussed in more detail in *7 Recent and Forthcoming Legal Developments* and 8 *Other Developments*, below.

### Surplus lines insurers

Some overseas insurers access the US insurance market without obtaining state insurance licences by providing excess and surplus lines coverage. The excess and surplus lines markets were developed in each state to provide coverage for large commercial and speciality risks which authorised insurers in the state might not have the capacity to write. Excess and surplus lines coverage can only be provided through excess and surplus lines producers licensed in the state of domicile of the insured and, traditionally, such producers have had to clear substantive and procedural hurdles to demonstrate that the coverage is appropriate for the excess and surplus lines market, such as obtaining three "declinations" from insurers admitted in the state, or meeting a specific exemption for specialty or large commercial coverage.

The excess and surplus lines eligibility rules for insurers and the standards for which risks can be written on an excess and surplus lines basis were streamlined and standardised on a nationwide basis by the Nonadmitted and Reinsurance Reform Act (NRRA), which was enacted as part of Dodd-Frank. Pursuant to the NRRA, each excess and surplus lines transaction is regulated only by the insured's home state. This means that only the insured's home state can determine whether the coverage is eligible to be written on an excess and surplus lines basis, place licensing restrictions on the producer involved in the transaction, and collect premium taxes.

The NRRA also creates a single national standard for insurer eligibility to write in the excess and surplus lines market. The NAIC maintains a Quarterly Listing of Alien Insurers, and no state may prohibit an overseas insurer on that list from writing excess and surplus lines insurance.

In addition, the NRRA creates a nationwide exempt commercial purchaser standard, which all states are required to accept. This means that the excess and surplus lines producer does not have to obtain declinations or clear other procedural hurdles if (i) the producer has disclosed to the prospective insured that the coverage may be available from an admitted carrier that may provide greater policyholder protection and regulatory oversight, and (ii) the insured subsequently requests, in writing, that the producer procure excess and surplus lines coverage.

### Self-procurement

Unauthorised overseas insurers can also issue policies to insureds in most US states through state "self-procurement" or "independent procurement" exceptions to state licensing rules. The two terms, which are generally interchangeable, are defined as transactions where the insured procures insurance directly from an unauthorised insurer without the involvement of an excess or surplus lines producer. The rationale for this exception is that businesses and individuals in the state are free to leave the state's admitted market to obtain coverage. This exception is a narrow one, and the rules relating to contacts with the insured and where the transaction occurs are intricate and vary from state to state.

## 4. Transaction activity

### 4.1 Mergers and acquisitions' activities

### Recent activity

After a record level of deal activity in 2015, which saw a number of mega-mergers exceeding USD1 billion, insurance M&A in the United States slowed in 2016, ending with aggregate deal volume (number of deals) roughly even with 2015 but aggregate deal value significantly decreased, by some estimates as much as 60%, though on par with the long-term average.

2016 was a year of uncertainty, marked by a number of destabilising developments, most notably the US presidential election and the UK's Brexit referendum. Despite the overall slowdown, deal volume increased in the second half of 2016, driven in part by Asian buyers interested in diversifying and entering the US market, as illustrated by Sampo Holdings' (Japan) acquisition of Bermuda-based Endurance Specialty Holdings, and China Oceanwide Holdings' announced acquisition of Genworth Financial. Other factors influencing deal activity in 2016 included US insurers divesting non-core legacy businesses, such as long-term care and mortgage insurance (Arch Capital Group's acquisition of United Guaranty Corp), and expanding into new specialty lines of business (Liberty Mutual's acquisition of Ironshore, and Fairfax Financial's acquisition of Allied World).

Notably, 2016 saw a continued focus among insurers on expanding their use of emerging technologies and investing in or acquiring insurtech companies (HSB's acquisition of Meshify, Allstate's acquisition of SquareTrade, and Intact Financial's investment in

Metromile), a trend that is expected to continue into 2017. As discussed in greater depth in the next section, technological innovation is having a significant impact on the industry. Insurers that do not have the capabilities to develop technological solutions in-house are looking to insurtech companies to fill this gap. Insurtech-driven dealmaking is taking many forms, including outright acquisitions, indirect investments in which carriers collaborate with insurtech firms on projects, and direct equity investments in insurtech companies.

Two of the top ten M&A deals in 2016 were insurance brokerage acquisitions, specifically B&T Corp.'s acquisition of Swett & Crawford and a management-led buyout of Acrisure, LLC. In addition, M&A activity in the insurance distribution space is on the rise, and this consolidation trend is expected to continue into 2017 as the low-interest-rate environment keeps debt inexpensive. As investment in distribution-side technology increases, insurtech-based M&A is expected to escalate as well, with brokerages being natural buyers.

The economic and political uncertainties that dogged 2016 continue to affect markets in 2017. As the industry shifts away from megadeals to consolidating and better managing existing business, inbound investment – particularly from the Chinese – continues to draw regulatory scrutiny. While interest rates remain relatively low and the stock market continues to rise, the political environment within the United States is extremely uncertain. The election of President Trump and a Republican Congress boded well for regulatory reform, but little has yet been achieved. Specifically with respect to the insurance industry, this includes uncertainty over the compliance date for the Department of Labor (DOL) Fiduciary Rule, the scope of the new administration's rollback of the Dodd-Frank Act, and whether the changes will affect insurers that have been designated systemically important financial institutions (SIFI) under the Act.

US regulators have a significant impact on deal-making. Since the NAIC's Insurance Holding Company System model law was adopted in 1969, the United States' state-based regulatory system has focused on insurer group supervision. The US approach to group supervision has been described as a "windows and walls" approach: state regulators have "windows" through which to view group activity and assess its potential impact on the ability of the insurer to pay future claims, and "walls" to protect the insurer's capital resources by requiring that the insurance commissioners review and approve all material transactions. Under the Holding Company Act, the state of domicile of an insurer must approve any outside acquisition through a process known as a "Form A," and frequently must approve ancillary agreements as well.

State regulators sometimes attempt to exercise authority over deals that are beyond their jurisdiction, particularly if the deal stands to affect the residents (and politics) of their state. In addition, federal regulators such as the Department of Justice can play a key role in the success or failure of a deal. Both these scenarios played out in the two great health insurance deal failures of 2016–17; the thwarted Cigna-Anthem and Aetna-Humana mergers. Both deals received significant non-domiciliary state scrutiny and criticism, and were ultimately ended after the DOJ initiated  lawsuits challenging them. Meanwhile,

China Oceanwide's proposed acquisition of Genworth Financial, despite receiving regulatory approvals in Delaware and Virginia, is still up in the air pending the outcome of an investigation by the Committee on Foreign Investment in the United States (CFIUS).

One expected result of the 2016 election is that the Trump administration and Republican-controlled Congress will return the states to their pre-eminent position as primary overseer of the US insurance industry. However, uncertainty continues to plague US politics and policy, which may inhibit both domestic and cross-border insurance M&A in the near term.

## 5. Insurtech

### 5.1 Insurtech development and collaborations

#### Insurtech developments

Recent years have seen insurance markets look to technological innovation to increase efficiency and enhance business operations. Insurtech – the use of technology in insurance transactions and processes – has emerged as an industry sector unto itself. Technology is disrupting and transforming across the insurance value chain, affecting product development, marketing, distribution, underwriting, pricing, administration and claims.

Insurtech has grown exponentially since it first emerged in 2011. According to research by venture capital database CB Insights, total funding to insurance startups in 2016 hit USD1.69 billion, in the second consecutive year where investment in the sector topped USD1 billion. Furthermore, in 2013 and 2014, 84% of private tech investments by reinsurers went to US-based insurtech companies, but between 2015 and 2016 only 6% of strategic tech investment by reinsurers went to the United States, as Germany, France, the UK and China also attracted deals. According to global advisory, broking and solutions firm Willis Towers Watson, insurtech funding volume in the second quarter of 2017 hovered close to USD1 billion – a 248% jump from the first quarter.

#### Incumbent insurer reaction

Due to a generally risk-averse culture and a dependency on proprietary legacy systems, many incumbent insurers were initially hesitant to adopt new technology, and the "wait and see" approach of many in the sector continues to cause it to lag behind financial services as a whole. However, as well-funded new insurtech entrants flood the market, insurers may reach a tipping point where they can no longer afford to sit on the sidelines while other financial services firms partner up with innovators. According to PwC's 2017 Global FinTech Survey, insurtech disruption is on the mind of 74% of global insurers, with 45% partnering with industry innovators (up from 28% in 2016).

Investing in insurtech can be an opportunity for insurers to expand products and services, increase customer base, optimise operating processes and generally stay competitive. Insurers and reinsurers are increasingly setting up their own venture capital arms and providing seed-stage funding to insurtech companies, forming joint ventures and partnerships with insurtech companies, or looking for acquisition targets. These strategic partnerships or mergers are not without their challenges. The cultural differences between a startup insurtech firm and an established insurer can create obstacles to collaborating, with the former finding incumbents frustrating and slow. According to PwC's 2017 Global FinTech Survey, while the majority of insurers see their company as being good at generating ideas, only 17% rated their ability to co-create with innovators as "good or very good."

#### Insurtech along the value chain

The insurance industry has historically been known for being paper intensive, for offering standardised products and using an opaque pricing model, for engaging with customers through agents and brokers, and for its use of outdated proprietary databases. Insurtech is moving the industry to engagement through multiple chains (social media, mobile, etc.) highly personalised products, transparent pricing, direct relationships with insureds, and the use of Big Data and automated processes.

Most initial insurtech innovation was on the distribution and retail side; technology was used to cut out "the middle man," allowing consumers a more direct relationship with the insurer, as well as more automation and self-direction in the purchase process. Insurtech's focus on multi-channel engagement and distribution is seen as key to attracting millennials, who interact more frequently and comfortably via social media and mobile devices, and who increasingly expect an "Amazon-like" purchasing experience.

Recently, insurtech's focus has shifted from consumer-facing innovation to the optimisation of back-office processes. Artificial intelligence is most likely to have an impact on areas where there are defined processes and procedures, such as claims processing and contract issuance. Companies are exploring how robotic process

automation ("robo-advisors" or "chatbots"), which is designed to simulate an intelligent conversation and replace humans in various processes, can be used to improve efficiency. Some insurers are already using mobile apps to assist in the underwriting and claims process. Insurtech is looking to continue advances in underwriting by exploiting the vast amounts of Big Data resulting from society's ever-increasing connectivity. Meanwhile, new data sources such as sensors and drones will affect claims adjustment, while blockchain technology and smart contracts ease insurance recordkeeping by streamlining data collection and payments processing, and automating insurance contracting and claims handling.

Insurtech is also having an impact on product development. The use of sensors (on cars, property and personal devices) to feed real-time information to insurers has enabled highly personalised products and pricing, including pay-as-you-go and pay-as-you-use products. Microinsurance (ie, protection against specific risks over a relatively short period of time) is also emerging in the United States. Rapidly underwritten, these products are being sold through mobile devices and are designed to cover things like laptops, cellphones and sporting/musical equipment.

### 5.2 Regulator's response to insurtech issues

#### Regulatory approach

With its large base of sophisticated consumers and vast pool of venture capital, the United States is an attractive marketplace for insurance innovation. However, the country's state-based regulatory scheme may present a challenge to industry innovators. Mostly drafted in the 20th century, these laws and regulations were designed to regulate the industry as it existed at the time. Realising the full potential of what insurtech has to offer requires a regulatory environment that is fluid and adaptable, not characteristics for which US state regulators are particularly known. In fact, US regulators have been slow to take an interest in industry innovation compared to their counterparts in the UK, Singapore and the United Arab Emirates, countries whose regulatory environments are more welcoming to innovation. Moreover, the United States' state-based regulatory system is itself a huge obstacle to innovation, with its complex patchwork of state laws and no single, centralised regulator.

US regulators are attempting to address these challenges. The NAIC (the US standard-setting and regulatory support organisation created and governed by the chief insurance regulators from the 50 states)

established the Innovation & Technology Taskforce, whose mission is "to provide a forum for regulator education and discussion of innovation and technology in the insurance sector, to monitor technology developments that impact the state insurance regulatory framework and to develop regulatory guidance, as appropriate." Along with the associated Big Data Working Group, Cybersecurity Working Group and Speed to Market Working Group, the taskforce is looking at the following innovation-related regulatory issues:

- the impact of the collection and use of Big Data, including its appropriate use in underwriting, rating and claims; privacy concerns; discriminatory pricing (using data to identify those known to be willing or able to pay more); and the possibility of a segment of the population being unable to obtain or afford insurance;
- regulatory issues raised by the use of autonomous vehicles;
- on-demand insurance applications and the implications for cancellations, non-renewals, notice provisions, coverage issues and policy-delivery requirements;
- changing the rate- and form-filing requirements to increase efficiency while protecting consumers; and
- developments in the area of cybersecurity.

As US regulators grapple with these issues, change to the regulatory status quo is likely to be slow.

## 6. Emerging risks and new products

### 6.1 Risks and regulator's reponse to risks

#### Longevity

Over the past 100 years, Americans' life expectancy has increased by about 25 years. From 1975-2015, life expectancy at birth in the United States increased from 68.8 to 76.3 years for males, and from 76.6 to 81.2 years for females. According to the National Institute on Aging, the 85-and-over population is projected to increase 351% between 2010 and 2050, and the over-65 population is projected to increase by 188%.

With this increase in longevity comes a greater risk of needing long-term care support services, with 70% of people over the age of 65 pedicted to need some sort of long-term care support. The Center for Retirement Research at Boston College estimates that 44% of men and 58% of women will need nursing home care at or after age 65. The average cost for nursing home care in the United States is USD253 per day or USD7,698 per month, and the average cost for an assisted living facility is USD3,628 per month.

Long-term care (LTC) insurance emerged in the late 1970s but did not become popular in the market until the late 1980s/early 1990s. It generally covers custodial care, home health care, hospice care, assisted living care, adult day care and skilled nursing care. As the baby boom generation began reaching age 65, it became clear that the first generation of LTC insurance policies were underpriced, due to claim assumptions that were too aggressive, underwriting practices that were too loose, and inaccurate mortality, lapse and interest rate assumptions. This has resulted in steep premium increases on the older products and steep prices for current products. While LTC insurance is still a viable option for many, overall sales have been decreasing, as have the number of insurers offering it.

As the popularity of LTC insurance wanes, the market has experienced a resurgence in "combination" products in which a rider offering "LTC insurance-like" benefits is sold with a life insurance policy or annuity. For example, an "accelerated death benefit" rider provides tax-free cash advances on the death benefit while the insured is still alive, often triggered by the insured's need for assistance with activities of daily living or cognitive impairment (typical LTC insurance eligibility standards). Some products also include a return-of-premium feature. Importantly, unlike traditional LTC insurance, which is paid on an expense-incurred basis, combo products have no restrictions on benefit usage and insureds/beneficiaries may use benefits to pay for long-term care services or for transportation, housekeeping, groceries, etc.

### Catastrophe: further leverage of the private insurance market

Flooding is the most frequent and most costly natural disaster in the US, and insurance penetration rates remain woefully inadequate. Additionally, research suggests that changing weather patterns and warming of the atmosphere is increasing the threat of flooding in certain parts of the United States, particularly the northern half.

The government-run National Flood Insurance Program (NFIP) is currently in nearly USD25 billion of debt to US taxpayers, and there is substantial and growing support by policymakers and regulators for the programme to be reformed, including through the acceleration of private flood insurance offerings. As the private flood insurance market builds in the US, so too will the need for increased diversification of flood risks through international risk pools, reinsurance and retrocession. US state insurance regulators' efforts to promote privatisation of the flood insurance market are starting to bear fruit, with early growth seen among international surplus lines carriers.

### Shared commerce

The explosive popularity of ride-sharing services and the online vacation-rental marketplace in the United States has attracted significant attention from state insurance regulators. In 2015, the NAIC adopted the "Transportation Network Company Insurance Principles for Legislators and Regulators" – a white paper specific to the ride-sharing industry, in which regulators identified coverage gaps resulting from typical commercial activity exclusions found in most personal auto insurance policies as the main risk to consumers. Although this white paper was specific to ride-sharing, the same risk exists with respect to vacation rentals, as the typical homeowner's insurance policy likewise excludes commercial activities from coverage. Although the regulation of shared commerce is in its infancy, the development of new products and coverage options is underway. A combination of policy endorsements and group product offerings is being developed to fill coverage gaps. These new products present many concerns for insurance regulators, including, but not limited to, the cost of coverage, individual vs. group programme structures, producer licensing and required consumer disclosures.

## 7. Recent and forthcoming legal developments

### 7.1 Legal developments and impact

The following litigation trends could have significant impacts on insurers providing coverage in the United States:

- Securities fraud: companies offering directors and officers (D&O) liability coverage are seeing an increase in cases alleging securities fraud. According to Nera Economic Consulting and Cornerstone Research, the number of federal securities class actions in 2016 was on par with the years following the dotcom crash in 2000. At least 80 merger objection actions were filed in 2016, which is a new record.

- Cyber liability: cyber liability claims relating to data breaches continue to be a concern for businesses in virtually every industry. Public companies victimised by cyberattacks are now almost routinely subject to class actions and shareholder derivative suits – even though no major data breach-related case has been successful to date. Cases against Target and Home Depot were unsuccessful last year, but Wendy's faces a shareholder derivation action, filed in December 2016, alleging that management and members of the board did not do enough to prevent a significant data breach.

- Class actions against property and casualty companies: several important trends are emerging in this area. First, there seems to be a growing cottage industry in some states in the Southern United States of plaintiffs' lawyers manufacturing bad faith claims by sending ambiguous, time-limited settlement demands to insurers. Second, courts are increasingly scrutinising and invalidating insurers' reservation of rights letters, exposing them to estoppel for mostly uncovered claims that they defend. Finally, insurers are facing growing litigation costs associated with claims among contractors, subcontractors and their respective insurers regarding which entities must indemnify or defend other entities under contractual "additional insured" language.

- Class actions against life companies: finally, a number of major US life insurers continue to face class actions relating to their cost-of-insurance increases on universal life insurance policies. The persistent low-interest-rate environment has pushed many life insurers to increase their cost-of-insurance charges, and creative plaintiff attorneys continue to explore legal theories challenging the increases.

## 8. Other developments

### 8.1 Promoting alternative risk transfer

Recent US regulatory developments of potential interest to overseas insurers include the US-EU "Covered Agreement" relating to reinsurance collateral and group supervision, the NAIC's adoption of principles-based reserving for life insurance, and efforts by New York regulators and the NAIC to adopt cybersecurity standards for insurers.

#### The US-EU covered agreement

Dodd-Frank authorised the USTR and newly created FIO to negotiate so-called "covered agreements" with foreign governments concerning the prudential regulation of insurers, so long as such agreements achieve a level of protection for US consumers that is substantially equivalent to the protection provided under US state insurance regulation.

In January 2017, in the waning days of the Obama Administration and after more than a year of negotiations, the USTR, FIO and their EU counterparts announced that they had completed negotiating a covered agreement (Covered Agreement) relating to reinsurance collateral rules and insurance group supervision. The Covered Agreement has been controversial. The NAIC and segments of the US insurance industry oppose it, arguing that it is vague and unclear on critical points, that it undermines individual state authority to regulate insurance in the US, and that it does not go far enough to ensure that the EU will recognise the US as an equivalent jurisdiction for purposes of its Solvency II prudential regulatory regime. Nevertheless, on July 14 the Trump administration announced that it will sign the Covered Agreement and issue a policy statement on implementation to address any unclear points.

The Covered Agreement has three major components: (i) eliminating collateral requirements under certain conditions; (ii) assigning the "home" jurisdiction regulator as the world-wide group supervisor for every insurance group; and (ii) setting forth best practices for the sharing of information among US and EU regulators. The first two components have the greatest potential to affect EU and US insurers doing business on a cross-border basis.

The Covered Agreement eliminates collateral equirements for reinsurers providing coverage on a cross-border basis between the US and EU. As a practical matter, this means that collateral requirements in all US states will be eliminated for EU-domiciled reinsurers that meet certain conditions similar to the certified reinsurer requirements that many states have already adopted.

To qualify, reinsurers must:

- maintain minimum capital and a surplus of $250 million;
- maintain prompt claims payment practices;
- agree to notify US state regulators of any adverse regulatory actions;
- agree not to participate in solvent schemes of arrangement involving ceding insurers in the relevant state without posting full collateral;
- and agree to fully collateralise reinsurance for ceding insurers that go into receivership (upon request of the relevant state regulator).

The Covered Agreement also clarifies that, as among EU and US regulators, the "home" state of every insurance group is its sole, worldwide group supervisor when certain conditions are met. The home jurisdiction is defined as the place where the group's overall parent has its headquarters or is domiciled. Any jurisdiction where the group has operations, other than the home jurisdiction, is a "host" jurisdiction. The Covered Agreement exempts insurance groups from any group capital requirements imposed by a host jurisdiction as long as the home jurisdiction (i) conducts a group capital assessment that captures risk at all levels and (ii) has full authority to impose corrective capital requirements at the group level.

The group supervision component of the Covered Agreement has little practical impact today because US state insurance regulators have no authority to impose capital requirements at the group level. While the NAIC has formed a working group to develop a US group capital calculation, thus far there has been no effort to give US states authority to impose capital requirements at the group level.

## Principles-based reserving

US life insurers and state insurance regulators are in the final stages of implementing principles-based reserving (PBR), a decade-long effort to shift the US regulatory scheme away from formulaic reserving requirements to a new, dynamic approach that more closely reflects the risks of today's complex insurance products. Regulators' concern with the formulaic approach was that it could lead to overly conservative reserve calculations for some products and inadequate reserves for others.

PBR has been controversial at times, with a number of key states resisting it until recently because they feared that state regulators would not have the capacity to evaluate the more complex reserving methodologies developed by the life insurers.

The NAIC adopted a Standard Valuation Law in 2009 and began work on a Valuation Manual that will set the framework for the new approach. The Valuation Manual was adopted by a supermajority of NAIC members in December 2012 and, in 2016, the NAIC decided that PBR would go into effect when at least 42 states – representing 75% of total US life insurance premium – had adopted the latest version of the Standard Valuation Law. By January 31, 2017, a total of 46 states – representing 85.7% of US life insurance premiums – had adopted the Standard Valuation Law, as a result of which full implementation of PBR is now underway pursuant to an NAIC implementation plan developed in 2013 and revised in April of 2017.

(www.naic.org/documents/committees_ex_pbr_implementation_tf_130712_pbr_implementation_plan_130824.pdf).

## Cybersecurity regulation

In February 2017, the New York Department of Financial Services (NYDFS) became the first state regulatory agency in the United States to adopt a regulation prescribing cybersecurity standards for its regulated entities (www.dfs.ny.gov/legal/regulations/adoptions/dfsrf500txt.pdf). NYDFS spent almost four years developing the regulation based on surveys of nearly 200 insurance and banking institutions, and correspondence and discussions with federal and state regulators, industry groups and consumer advocates.

In 2015, the NAIC formed a Cybersecurity Task Force that has been working on a Data Security Model Law. There have been recent indications that the task force may be moving toward a model law patterned closely on the NYDFS regulation.

In many ways, the NYDFS regulation is modelled on the provisions of GLB that regulate financial institutions' collection, use, protection and disclosure of non-public personal information. The NYDFS regulation, however, applies much more broadly to any entity "operating under or required to operate under a license, registration, charter, certificate, permit, accreditation or similar authorisation under the Banking Law, the Insurance Law or the Financial Services Law." New York's size and the state's status as a major financial services

and commercial hub mean that a large percentage of insurance and other financial services companies operating in the US are subject to the NYDFS regulation.

Like GLB, the NYDFS regulation focuses on a company's systems and procedures for protecting non-public information, defined as either:business information that, if disclosed, would have a material adverse impact on the company; or sensitive personal information concerning individuals, whether they are customers of the entity or not.

The NYDFS regulation has the following key components:

- Cybersecurity programme: each covered entity must adopt a cybersecurity programme, which must include periodic risk assessments, annual penetration testing, audit trail systems, personnel training and monitoring, and an incident response plan.

- Chief information security officer: each covered entity must appoint a chief information security officer (CISO) and have sufficient personnel to manage cybersecurity risk.

- Board oversight: each covered entity must have a written cybersecurity policy that is reviewed annually by its board and approved by a senior officer.

- Third-party service provider policy: each covered entity must have a third-party service provider policy designed to ensure that the entity's information systems and non-public information are secure.

- Encryption and multi-factor authentication: the NYDFS regulation generally focuses on governance and process allowing companies to design appropriate cybersecurity measures to meet its risks, but also requires two substantive cybersecurity measures – the encryption of non-public information both in transit and at rest, and the use of multi-factor authentication when an individual accesses the entity's internal network from an external network. The encryption requirement has a five-year phase-in period, and an entity does not have to encrypt information if its CISO finds that such encryption is "infeasible." Similarly, the entity does not have to use multi-factor authentication if its CISO has "approved in writing the use of reasonably equivalent or more secure access controls."

- Reports and notices to NYDFS: the NYDFS regulation requires each covered entity to report annually to NYDFS on its cybersecurity programme. In addition, covered entities must report any cybersecurity incident that has a "reasonable likelihood of materially affecting the normal operation of the Covered Entity or that affects Non-public Information" as soon as possible, and no later than 72 hours after becoming aware of an event.

Within the next six months to a year, the NAIC is likely to adopt a model law that includes most, if not all, of the above components, meaning that all insurance entities operating in the United States will likely be subject to the NYDFS standards in the not-too-distant future.

### The CFPB

Dodd-Frank created the Consumer Financial Protection Bureau (CFPB). Although "insurance" is excluded from this agency's jurisdiction, the CFPB has authority over insurance companies and non-industry players with insurance operations under certain circumstances. For example, the CFPB has authority over an insurance company that provides a "consumer financial product or service" such as insurance premium financing. It is also authorised to intervene where any company is deemed to have engaged in "unfair deceptive and abusive acts and practices" ("UDAAP"). Most notably, the CFPB has begun to focus on insurance, extended warranty and service contract "add-ons" offered to consumers, particularly when coupled with financing. The recent trend of CFPB subpoenas, enforcement actions and penalties is expected to continue.

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