INSURANCE SECTOR TRENDS: 2017 YEAR END REVIEW AND FORECAST FOR 2018

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INTRODUCTION

In just the last year:

- President Trump was inaugurated
- The US and EU signed an unprecedented "covered agreement"
- Europe faced several critical national elections, emerged largely intact, but more to come
- Brexit started to bite
- More than 3,500 insurance and technology people gathered at *InsureTech Connect*
- There were $306 billion in economic losses from natural and man-made disasters. Only a third of these disaster losses were insured – an industry indictment/opportunity
- AIG and MetLife ceased to be non-bank SIFIs
- Regulators pivoted from entity-based to activities-based assessments of systemic risk
- CVS signed to acquire Aetna in a $69 billion game-changing pending transaction
- Life and non-life companies continued to shed non-core or under-performing business
- The IAIS appointed a new Secretary General
- A possible endgame was announced for ICS
- The NAIC appointed a new CEO
- The US got 19 new insurance commissioners
- FIO got a new Director (Acting)
- NFIP was attacked and tested while waiting for a long-term extension
- The US passed a landmark tax bill

These and other developments reflect a volatile, challenging time for the insurance industry. As we do every year, this *Year End Review and Forecast* assesses the impact and implications of major developments around the globe and, after looking into our crystal ball, we offer some thoughts on what 2018 might bring.

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GLOBAL DEVELOPMENTS DRIVING OPPORTUNITIES AND CHALLENGES

Increasingly, developments at a global level are defining the opportunities and challenges that face the insurance sector. This is true for purely domestic carriers and insurers who are actively in multiple markets. These events are driven by post financial crisis awareness that financial instability in one region can spread and impact operations in another. But beyond this, developments in the use of technology, increasing cybersecurity concerns, increasingly global businesses creating insureds who need risk management solutions crossing multiple national borders, and macro-economic and political events that either stimulate or curtail market developments are all shaping the opportunities and challenges for the insurance sector. In the midst of this, the IAIS continues to evolve, expand its agenda and is an increasing force driving the global regulatory dialogue. In addition, bi-lateral or multi-lateral agreements between countries are beginning to re-shape market access and regulatory relationships.

In 2017, we saw these trends play out in connection with the following:

Brexit

Brexit dominated much of the political, economic and regulatory dialogue. Progress has been slow and torturous and has continued to be a hugely important issue for UK and European insurers in 2017.

Political Developments in 2017

The UK government served notice in March 2017 under Article 50 of the EU treaty for the UK to leave the EU. In January, in a speech at Lancaster House in London, the UK Prime Minister Theresa May confirmed that her government's intention was for the UK to leave the European single market as well as the EU. She confirmed that the government would seek an agreement on the future relationship between the UK and EU within the two-year negotiating period triggered by serving notice under Article 50; and that the government intended to negotiate a phased, but time-limited, process of implementation to commence following the expiry of the two-year period.

Following a vote in Parliament, the UK government served notice under Article 50 on March 29, 2017. As a result, unless some other agreement is reached between the UK and the EU, the UK will leave the EU at 11:00 pm UK time on March 29, 2019.

In June, Theresa May saw her hand in Brexit negotiations with the EU significantly weakened following an unexpectedly strong performance from the UK's main opposition Labour party in a general election. Mrs. May had called the election in the expectation of increasing her government's slim parliamentary majority; but she lost that majority, and has since had to rely on the support of the Northern Irish Democratic Unionist Party to stay in power.

In September, in a further major speech in Florence, Mrs. May confirmed that the UK would seek a "status quo" transition period of approximately two years, and indicated that the UK accepted that it would need to make a very substantial payment to the EU as part of a "divorce settlement." In December, despite considerable difficulty over the status of the UK's land border with the EU in Ireland after Brexit, the EU heads of government confirmed that sufficient progress had been made in respect of that and the other two identified "separation issues" of the financial settlement, and citizens' rights, for Brexit talks to proceed to the terms of a transition period and to the UK's future trading relationship with the EU, in 2018.

In advance of trade talks, the UK government is expected to set out its aspirations for that trading relationship, presumably including more detail of what it will seek for the financial sector including the insurance industry, early in 2018.

Impact on Insurance Groups

For the insurance sector, 2017 did little to eliminate the uncertainty about both the "end state" for the UK's trading relationship with the EU in insurance services, and whether there will be a transitional period before the end state is reached, including what that transitional period will look like. Insurers will certainly be pleased that Brexit negotiations are now moving forward. However, the negotiations to date have already been difficult, and there seems to be considerable distance between initial positions taken by some on the EU side (that the UK will only be offered a deal similar to the existing EU trade deal with Canada, which covers goods but not financial or other services) and the UK government (which has suggested that it will seek a bespoke deal covering services – presumably including insurance). Insurers should therefore expect continuing uncertainty over transition and the trade end state well into 2018. The mantra of EU negotiations, "nothing is agreed until everything is agreed," means that uncertainty is likely to continue until a final deal is done, and in the meantime, there can be no guarantee that a deal will be done at all.

Insurers have therefore had to continue with Brexit contingency plans on the worst case assumption that the UK will leave the single market, ending reciprocal passporting of insurance services between the UK and the EU, and without any transition period having been agreed, at the end of March 2019 – *ie* there will be a cliff edge hard Brexit. This would mean that UK insurers currently operating through branches and providing insurance services cross-border in Europe will no longer be able to rely on EU single market rights to underwrite policies and pay claims, and EU insurers currently passporting in to the UK will no longer be able to underwrite and pay claims in the UK; this includes paying claims arising after Brexit on cross-border policies issued before Brexit. Those insurance groups who want to continue doing business after a hard Brexit must plan to have a risk carrying entity or entities independently licensed both in the UK and in a continuing EU member state, when Brexit happens. 2017 has seen many insurers move into the implementation phase of their Brexit reorganization plans to achieve this.

Brexit Reorganizations

Different strategies are being adopted. Many groups have chosen to incorporate new insurance companies in one of the 27 continuing EU jurisdictions or have sought or are seeking to revive insurers currently in run off, or are planning to significantly expand the business of an existing UK or EU licensed insurance company in their group.

Many insurers must now divide their portfolio of risks between a UK and an EU entity. If business is sufficiently short tail, and their plans are sufficiently advanced, it has been possible for some insurance groups to "run up" business in a new EU hub insurer and "run down" the EU business previously underwritten by the same group's UK insurer, renewing EU risks in the insurer based in a continuing EU country.

Other insurance groups are undertaking portfolio transfer processes, to transfer EU risks to a continuing EU insurer, and UK risks to a UK insurer.

A third strategy is seeking to redomicile a UK insurance company to a continuing EU jurisdiction. A number of insurance groups are converting or have converted UK insurers into European companies (SEs) under the EU statute for a European company. Under EU law, SEs are able to transfer from one EU jurisdiction to another. While the UK remains in the EU, it is therefore possible for UK insurers to convert to SEs and re-domicile to a continuing member state. Insurers taking this course will apply to have a UK branch of the insurer which is re-domiciling separately authorized in the UK, on the basis that its new UK license will only take effect at the point when the UK leaves the EU single market for insurance. This structure has the advantage of avoiding the need for separate insurance companies for the UK and the EU and for lengthy and complex portfolio transfer processes. After Brexit the same insurance company will continue to be licensed in both the EU and the UK.

EU insurers underwriting business cross-border and through branches in the UK have also been considering and putting into place Brexit plans. Some are looking to wind down their UK business, or to transfer it to a UK authorized insurer. Others will be seeking to obtain UK authorizations for existing branches, or to establish separate UK subsidiaries; in which case they may need a portfolio transfer so that existing policies written on a passported basis can be carried out by the new entity.

EU to Move against "Third Country" Outsourcing and Risk Transfer; and Regulatory Arbitrage?

A number of insurers have proposals that are designed to minimize disruption to their operations in Europe. UK-based insurance groups restructuring because of Brexit seemingly would prefer to retain their headquarters in the UK. During the course of 2017, however, the regulatory environment in Europe has become increasingly hostile to operating models that (i) depend on European insurers acting as a "front" for risk carriers in the UK or in other third country jurisdictions; and/or (ii) on substantial outsourcing of activity back to the UK post-Brexit or to other third countries. Steps may be taken at EU level to bring into line EU member state regulators who are perceived to have taken a more liberal approach to insurers applying for authorization in their jurisdictions.

In July 2017, European Insurance and Occupational Pensions Authority (EIOPA), the European Supervisory Authority responsible for the insurance sector, published its "Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union," confirming EIOPA's expectation that EU insurers show an appropriate level of corporate substance in their jurisdictions, and that a minimum level of risks should be retained by insurers – 10 percent was suggested. EIOPA also stressed that outsourcing by EU insurers should not be permitted if it would materially impair the quality of governance, increase operational risk, or impair the ability of EU regulators to monitor compliance. EIOPA stressed the importance in the light of Brexit of ensuring a consistent supervisory approach across the EU in particular to the relocation of insurers from the UK. The clear theme was that member states and their regulators should not engage in regulatory arbitrage to attract a larger share of business from the UK and that the flexibility allowed to member state regulators under the EU Solvency II Directive should not be a means for lowering standards or for disregarding prudential requirements.

Post-Brexit trading relationships in financial services (including insurance) between the UK and the EU are likely to be at the heart of the coming rounds of negotiations between the UK and the EU. So there is every chance that the relatively protectionist approach suggested by this proposal will give way to a more open relationship between the EU and UK insurance sectors, as part of a "Brexit deal" – but it is very hard to predict how these issues will ultimately turn out.

Statements Concerning UK Regulators' Approach

The Bank of England and PRA issued public statements that they would extend the broad approach already applied to banks from "third countries" that they expect to operate through subsidiaries rather than branches if they have material UK retail deposits. Insurers would be treated as having material retail business if their liabilities are protected by the UK Financial Services Compensation Scheme – the UK's statutory Policyholder Protection Scheme, which pays compensation to retail and certain small business policyholders (and larger policyholders with cover for UK compulsory employer's liability and motor risks) in the event of insurer insolvency. Where protected liabilities are likely to be greater than £200 million, the PRA would expect a European insurer that wishes to continue doing business after Brexit to establish a separate UK subsidiary. Insurers with a lower level of or no protected liabilities would not need to establish a subsidiary and are encouraged to establish a UK branch.

The PRA states that its willingness to allow incoming insurers to operate through a branch is dependent on its assessment of whether the relevant home state regulatory regime meets international standards, and, importantly, the level of cooperation between the PRA and the home state supervisor. The PRA's presumption is that there will continue to be a high degree of supervisory cooperation with the EU following Brexit, and that EU regulatory regimes will continue to meet the PRA's expectations for regulatory equivalence, and assurance over how resolution of incoming European firms would take place, in the event of a failure.

The UK government's promise to legislate if necessary to mitigate the consequences of a cliff edge for insurers doing business in the UK if an implementation period is not agreed between the UK and the EU, and the PRA's clarification of its proposed approach to authorizations, does mean that EEA insurers can continue their Brexit planning with a clearer idea of how they will be able to continue to operate in the UK as Brexit unfolds.

However, the PRA's recent communications have also made it clear that: insurers must continue to proceed on the basis of "prudent planning assumptions" about Brexit; firms that will need to authorize a branch or a subsidiary should begin preparing for authorization now (the government's promise of a temporary permission regime should be treated only as a fallback position); and the PRA's own working assumption that regulatory equivalence and cooperation with the EU will continue after Brexit so it is able to authorize and supervise UK branches of EU firms will remain under review as the UK/EU negotiations continue.

The EU-US Covered Agreement

The Dodd-Frank Act authorizes the Treasury, through the Federal Insurance Office and the Office of the US Trade Representative to jointly negotiate agreements with one or more foreign governments, authorities or regulatory entities, regarding prudential measures with respect to insurance or reinsurance.

On January 13, 2017, after many months of confidential negotiations, the United States and the EU announced that they had completed negotiation of such an agreement, entitled the "Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance" (Covered Agreement). The Covered Agreement was signed by officials representing Treasury, the USTR, and the EU on September 22, 2017; and following additional procedural requirements went into provisional effect on November 7, 2017, pending final approval by the European Parliament. A Signing Statement that was issued in connection with the September 22, 2017 execution of the Covered Agreement expresses how the US interprets some of the key provisions of the Covered Agreement.

The Covered Agreement sets several new precedents regarding mutual recognition of US state-based insurance standards and supervision. It also establishes thresholds for potential federal preemption of state insurance law. The Covered Agreement addresses two significant substantive issues: freedom of cross-border reinsurance transactions from local presence and collateral requirements and recognition of the group supervision sovereignty of both the US and the EU.

With respect to reinsurance, the Covered Agreement significantly modifies both collateral and local presence requirements for US and EU reinsurers operating on a cross-border basis that result in "less favorable" treatment of "Home Party Assuming Reinsurers" than assuming reinsurers based in the territory of the "Host Party Ceding Insurer." The Covered Agreement uses the term "Home Party" to refer to the territory (*ie*, the US or the EU) in which the worldwide parent of an insurance or reinsurance group has its head office or is domiciled. The term "Host Party" is used to refer to the territory in which an insurance or reinsurance group has operations, but is not where the group's worldwide parent has its head office or is domiciled.

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

With respect to group supervision, the Covered Agreement provides ground rules for the exercise of group supervision by the EU and US over insurance holding companies from the other jurisdiction by establishing two fundamental precepts:

- First, an EU or US Home Party insurance or reinsurance group is subject to worldwide prudential insurance group supervision only by its Home supervisory authority and is not subject to group supervision at the level of the worldwide parent undertaking of the insurance or reinsurance group by any Host supervisory authority; and
- Second, the Host supervisor "may exercise group supervision, where appropriate, with regard to a Home Party insurance or reinsurance group at the level of the parent undertaking in its territory."

According to the Signing Statement, these provisions mean "that US insurers and reinsurers can operate in the EU without the US parent being subject to the group level governance, solvency and capital, and reporting requirements of Solvency II, and reinforces that the EU system of prudential insurance supervision is not the system in the United States."

The Covered Agreement has a somewhat controversial history. For many years the NAIC actively opposed the efforts by the Federal Insurance Office to negotiate the Covered Agreement fearing that it would preempt state insurance laws. When the Covered Agreement was finally signed and the Signing Statement issued, however, the NAIC appeared to cautiously support the agreement, particularly because of the "affirmation of the primacy of state regulation" expressed in the Signing Statement, according to a statement by NAIC then-President Ted Nickel.

Considerable work is ahead, though, to ensure the Covered Agreement is implemented. In particular, the Covered Agreement establishes a five-year time frame within which the US states are "encouraged" to reduce reinsurance collateral requirements by 20 percent per year. The NAIC has said it plans to hold a day-long hearing on February 20, 2018, to solicit views as to how to do this and to address any other issues related to the Covered Agreement. Also, the effectiveness of the terms of the Covered Agreement is mutually dependent. That is, for example, the collateral reduction provisions desired by the EU are effective only if the elimination of physical presence requirements and limitation on worldwide group supervision desired by the US are in place, and vice versa. Accordingly, if a problem develops regarding one aspect of the Covered Agreement, it could have a ripple effect on the entire agreement.

Two other aspects of the Covered Agreement bear watching as it begins to go into effect:

- First, the Covered Agreement establishes a "Joint Committee" that is responsible for the implementation and administration of the Covered Agreement. It is supposed to meet within 180 days after the provisional application of the Covered Agreement, which as previously noted occurred on November 7, 2017. However, the Covered Agreement does not spell out the number and identity of the representatives to the Joint Committee, nor is there a clearly defined role for state regulators or for EU national regulators. It will be interesting to see how the Joint Committee is organized and what, exactly, it does.
- Second, either party may terminate the Covered Agreement with relative ease, which makes it potentially vulnerable to political exigencies. And, in 2018, there are ample sources for political exigencies to occur.

Systemic Risk Analyses

Throughout 2017, there were a number of developments that called into question the continued focus on and special regulation of insurers who have been designated as systemically important.

Activities Based Approach

The Financial Stability Board, in consultation with the IAIS, issued a press release on November 21, 2017, announcing that it had decided not to publish a new list of G-SIIs for 2017. The press release notes the IAIS's work on the Activities-Based Approach to systemic risk (ABA) may have significant implications for the assessment of system risk and therefore identification of G-SIIs and G-SII policy measures. Nevertheless, the FSB stated that current G-SII policy measures would continue to apply to the nine firms on the 2016 G-SII list (including three US companies).

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

On December 8, 2017, the IAIS issued a consultation document seeking comments on its plans to develop the ABA, which if and when adopted will replace the current entity-based approach.

The IAIS is not rushing into this change, though, because the current consultation is characterized as an "interim" document which is "intended to provide an opportunity for stakeholders to provide feedback on the development of the approach and structure" of the IAIS's work on this topic. As such, the consultation does not include "conclusive proposals." Nevertheless, the document provides a conceptual framework showing the IAIS's current assumption that there likely are activities that insurers engage in which could potentially threaten global financial stability and which may not be sufficiently monitored and/or mitigated by current supervisory tools and authority.

In any event, the interim consultation will result in a more formal consultation in 2018, followed by additional analysis and stakeholder input before the ABA is adopted. The IAIS's objective is to adopt the ABA in 2019 for implementation in 2020.

Many in the industry have given their initial support to the ABA, particularly those in the current cohort of companies which are considered to be G-SIIs under the existing entity based approach. However, some concerns have already been expressed that companies which are not currently systemically important will come under more intense scrutiny under an ABA as supervisors assess whether an insurer engages in systemically important activity. Similarly, early concerns have been expressed that any new mitigation powers must be cost-effective and proportional to the perceived risk presented by any activity.

This topic will likely receive considerable attention in 2018, beginning with a stakeholder session on February 1, 2018 at the Bank of England in London.

G-SII/SIFI Developments

The Financial Stability Oversight Council (FSOC) met in September, October and November. During the September meeting, AIG's designation as a non-bank systemically important financial institution was rescinded. The decision acknowledged developments and enhancements to state insurance regulation since the original designation, including the work that is being done by the NAIC's Financial Stability Task Force through the Macroprudential Initiative, discussed in further detail below.

Systemic risk, however, continues to remain a major concern of virtually every financial services regulator. Lessons learned from the financial crisis are still a matter of principal focus of regulators around the world. The threat has not receded that the entire financial system or the financial markets may collapse as a result of a combination of factors such as counterparties failing to meet their obligations causing a domino effect, a fire sale of assets causing an extreme drop in values, a contagion effect that spreads throughout the market, the inability to isolate the contagion because of the interdependence and interconnectedness of the financial firms, the discontinuation of a critical function in the financial system where no other entity can be substituted to perform that function, and an extreme loss of confidence by market participants so that liquidity dries up and the market participants hold on to assets creating a "seizing-up" of the market.

Although the insurance industry was not a direct cause of the financial crisis, insurance markets have become increasingly global and their activities have become interconnected with the financial markets. Therefore, regulators both in the US and overseas are still trying to find the right mix and degree of regulation to provide for the necessary resilience of the financial system to withstand another severe adverse shock.

In 2017, the regulatory environment seemed to take a different direction to address systemic risk 10 years after the worst part of the crisis. Previously, under the Dodd-Frank Act, bank holding companies with US$50 billion or more in consolidated assets would be treated as systemically important financial institutions and subject to enhanced prudential regulation and oversight. FSOC was also empowered to identify systemically important nonbank financial companies which would be subject to enhanced regulatory oversight. In addition, FSOC had the power to recommend heightened prudential standards to apply to any "activity" that FSOC identified as contributing to systemic risk.

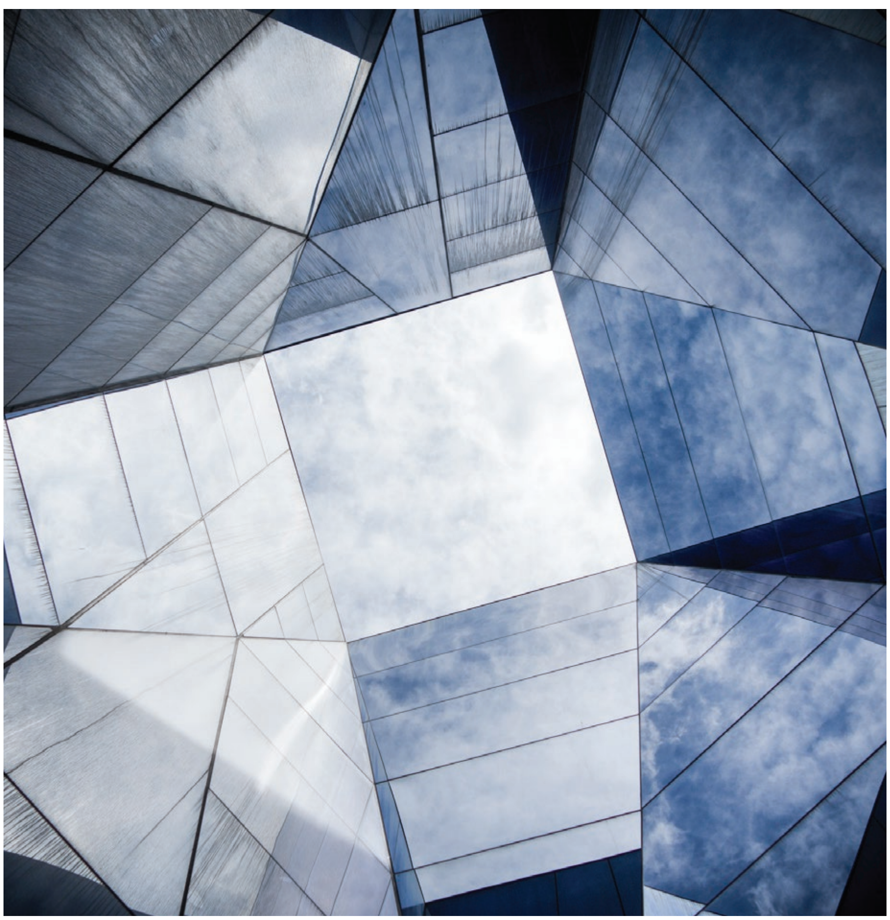
With the election of President Trump and a global reaction to less regulation as the pendulum of regulation began to swing back from stringent regulatory oversight established in a time of crisis, both the US and the EU reevaluated whether designating nonbank financial companies was an appropriate way to deal with systemic risk. In the November 17, 2017 Treasury report, *Financial Stability Oversight Counsel Designations*, Treasury reviewed and addressed the numerous and significant criticisms of the designation process. While the report did not recommend the elimination of FSOC's designation authority, it highlighted the need to make every effort for FSOC to be rigorous, clear and comprehensible to firms and to the public, and to take actions of designation only when the expected benefits to financial stability exceed the costs imposed on the designated firm. Treasury concluded that designating companies was a "blunt instrument" for addressing potential risks to financial stability and instead recommended that FSOC prioritize its efforts to address risks to financial stability through a process that emphasizes an activities-based or industry-wide approach and work with primary regulators to address any systemic concerns. If, after such an approach is utilized, it is determined that one or more firms still may pose risks to financial stability, FSOC should consider an entity-based designation at that time. Treasury also recommended that there be a clear off-ramp process for designated nonbank financial companies. The Treasury report endorsed many positions advocated by state insurance regulators.

De-designation of SIFIs

As a practical matter, much of this reprioritization has already happened in the US. Originally, between 2013-2014, FSOC designated four nonbank financial entities: GE Capital, AIG, MetLife and Prudential. The current status of each original SIFI is as follows:

- **AIG.** In September 2017, AIG was de-designated as it convinced FSOC that it had dramatically changed its business by significantly de-risking its businesses, substantially reducing its leverage, its debt, its derivative positions, its securities lending and its repurchase agreements, and drastically shrinking in size. In making its final determination, FSOC evaluated the extent to which material financial distress at AIG could be transmitted to other financial firms and the markets and thereby pose a threat to US financial stability through three main channels: (1) exposure to creditors, counterparties, investors and other market participants to AIG (interconnectedness); (2) the liquidation of assets by AIG which could trigger disruption to the key markets and market participants; and (3) the inability of AIG to provide a critical function or service relied upon by market participants and for which there are no ready substitutes. FSOC concluded that any impact through the three transmission channels would be minimal. FSOC said that "AIG is notably different from the company as it existed leading up to the financial crisis."

  FSOC needed a majority vote of its 10 members in order to rescind the AIG designation. The SEC Chairman had to recuse himself and did not participate in the vote. Three FSOC members, Cordoray of the CFPB, Gruenberg of the FDIC and Watt of the FHFA, opposed rescinding the designation which left six out of nine FSOC members voting in favor, which was a majority. It is interesting to note that legislation was passed in 2017 to extend the term of Roy Woodall, the Independent Member with Insurance



Expertise, to remain a member of FSOC. However, in November 2017, Tom Workman (a longtime president of the Life Insurance Council of New York, Inc., a leading New York trade group for the life-insurance industry) was reported to be nominated by President Trump and appointed to serve as the independent member. If confirmed, he would be one of 10 voting members and will serve a six-year term.

- **MetLife.** MetLife sued FSOC in the courts to have its designation rescinded and received a favorable opinion in March 2016 at the district court level, but Treasury appealed to the appellate court. Even though the appellate court had not rendered a decision, on January 18, 2018, MetLife and FSOC settled and agreed to end an appeal of a judge's order releasing the insurer from its status as a SIFI, effectively ending the fight.
- **GE.** In 2016, GE Capital was de-designated as a result of selling off most of its financial assets.
- **Prudential.** Prudential has not yet been de-designated, but it is pursuing to have its designation rescinded.

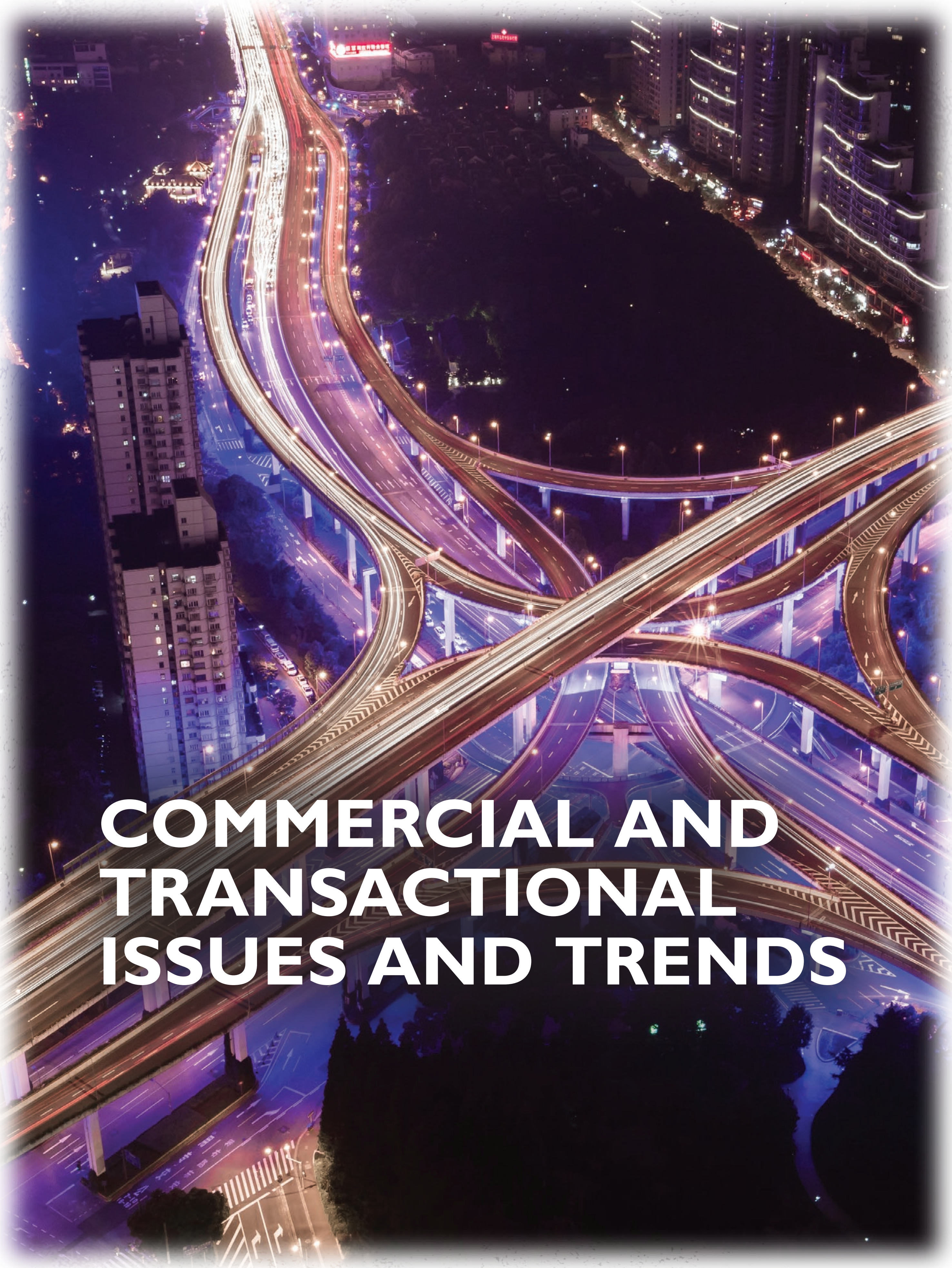
Similarly on the international stage, the FSB did not publish a list of G-SIIs in 2017. It is unclear whether the FSB will pursue entity-based designation. The IAIS has indicated that the preferred approach should be activities-based designation and is devising potential guidelines on that approach.

Increasing Protectionism

Although there are pronounced trends regarding the globalization of the insurance industry and increasing risks that call out for global insurance capacity, there is also a rising trend in protectionism. This is seen in restrictions in many countries regarding equity ownership caps, restrictions on cross-border reinsurance, mandatory cessions to local reinsurers, restrictions on granting licenses, local presence requirement, tax policies and other provisions. By design, these laws and regulations are blocking or curtailing the expansion of global insurers and, inevitably, having profound impacts on a number of local markets. Examples of problematic countries include G20 behemoths such as India, China and Brazil, but also a number of emerging economies. Moreover, many are watching the unfolding drama surrounding Brexit and can see hints that policyholder protection and secure and stable markets may not be the only goals in establishing the new regulatory rules.

Although, in some cases, restrictive laws are put in place for the stated goal of helping to build a domestic industry, in many countries the goals seem much more basic. As many of these laws and restrictions may have now been in place for years, if not decades, the goals seem to be more about just protecting market share than market promotion. The impact, of course, is that these restrictions prevent the deployment of capital, risk capacity and technical underwriting and insurance operational knowledge – to the detriment of the subject country. Emerging risk – whether the growing (in frequency and severity) risks of natural disasters or hard to underwrite risks (such as cybersecurity) – are often best underwritten, or only underwritten by the global insurance and reinsurance industry.

We fear this trend will continue, but we hope that governments, regulators and the industry will take steps to reverse this direction.



COMMERCIAL AND TRANSACTIONAL ISSUES AND TRENDS

Global Trends in Insurance M&A in 2017 and a Look Ahead

We reported in 2017 that M&A activity would continue to be strong in 2017 but with smaller-scale transactions than in prior years. While deal-flow has been very good, the insurance M&A market has indeed continued to slow throughout 2017, in a trend that started in 2016, with a trend towards smaller-scale sales and acquisitions. However, given market forces and stated corporate intentions (such as those by AIG, Zurich and others), we could see a return to larger, transformative transactions in 2018.

Insurers also continue to reflect on their core activities and markets and are seeking to align their business structures accordingly. Insurers are also responding to innovation and disruption from industry newcomers and InsurTech, seeking out opportunities to grow new product and technology channels as they work to keep pace with technological developments in the industry.

In this section of the *Year End Review,* we look back at 2017 outlining some of our observations of the insurance M&A market from the last year. We also look to the year ahead and consider how insurers' transactional appetites are likely to play out in 2018.

2017 in Brief

As mentioned, 2017 saw the continuation of the insurance M&A slowdown that started in 2016. The first half of 2017 saw 170 deals compared with 186 in the six months prior, which represents a 24 percent drop from the highs of H1 2015. Europe and Asia were hit particularly hard yet the Americas remained notably buoyant. However, as we note later in this *Year End Review*, although the numbers are down from their peak, there have been significant strategic plays by a number of global insurance groups in 2017, demonstrating that, while there have been significant consolidation in the market over the past 12 – 24 months, there are still key strategic growth opportunities.

2017 did nonetheless see several significant transactions globally: KB Financial Group's acquisition of KB Insurance (US$1 billion); China Development Financial Holdings' acquisition of China Life Insurance (US$1 billion); AXIS Capital Holdings' acquisition of Novae Group (US$618 million); Banco Bpm Gruppo Bancario's acquisition of Popolare Vita from UnipolSai Assicurazioni (US$612 million); Santalucia Seguros' acquisition of three Spanish entities from Aviva (US$517 million); Zurich Insurance's proposed acquisition of ANZ's life insurance business (US$2.2 billion); and MetLife's spin off of Brighthouse Financial. We have also seen significant activity in the health insurance space with Aetna's merger with CVS (US$77 billion), which we anticipate will drive further similar deals in the year ahead.

These deals demonstrate that there is still appetite within the market globally to pursue significant transactions, albeit there are other factors now driving their M&A and corporate strategies that mean large-scale market consolidations of previous years have given way to more strategic moves with a view to brand strength and innovation.

Key Trends 2017

M&A slowdown. It is clear just from looking at the numbers that M&A in the insurance sector is slower than recent years, and indeed two potential megamergers were blocked by US judges on antitrust grounds: Anthem's bid for Cigna (US$48 billion) and Aetna's bid for Humana (US$37 billion). At the lower end of the market, deal volumes have also been relatively lower due to geopolitical uncertainty caused by ongoing uncertainty related to Brexit in the UK and Europe, the Trump administration's difficulties in pursuing its legislative agenda and Chinese capital controls. It is worth noting, however, that M&A in the Americas has been notably active over 2017 when compared with the rest of the world. This is considered in the "Latin America Developments" section of this *Year End Review*.

Asian developments. Along with relatively good GDP growth momentum, aging demographics are also spurring demand for insurance in Asia, in particular, in view of still low insurance density and penetration rates in most Asian economies. Long-term demand for life insurance will also be driven by Asia's (especially in China, India and Indonesia) sheer population size, rising income and wealth, and the existing significant protection gap. These macro-economic factors combined with the scarcity of good targets in Asia generally and the inability in certain Asia jurisdictions (like Malaysia) to obtain new licenses, will continue driving an active Asia insurance M&A market (where, in our experience, every sale is run as a competitive auction process) for not only the international US and European headquartered insurers, but also the increasingly active Asia headquartered insurers from Mainland China, Hong Kong, Japan, Singapore and South Korea. While we will continue to see high valuations on these deals, especially for targets with highly sought after bancassurance or agency distribution channels, the dominance of Mainland Chinese bidders willing to pay the highest price (often times with very light touch due diligence) should be giving way to a greater diversity of winning bidders from Asia and elsewhere as the sellers and their financial advisers become more worried about China's execution risks given the continuing foreign exchange controls affecting Mainland Chinese bidders without offshore funding sources.

Deeper adoption of technology is changing the industry's business model and operations, as well as the delivery of insurance products. We are seeing this not only in the increasing automation of existing business processes (eg, the underwriting and claims processes), but also in traditional insurers establishing completely online/digital business divisions to distribute insurance products and provide robo-advice, which is part of a disintermediation trend among an increasing number of international insurers. The increasing business potential of big data and data-analytics is also producing a number of ground-breaking non-traditional JVs between traditional insurers (like Aviva, Ping An and Allianz) and many of the Chinese technology giants (Alibaba, Baidu and Tencent) to set up/grow online only insurers in Mainland China and Hong Kong. The big prize for these JVs is clearly the massive Chinese insurance market with its ever increasing middle-class and mass affluent populations (some of the tier 2 and tier 3 cities have more than 10 million inhabitants) and low insurance density and penetration rates. We would expect similar JVs to also start emerging in other Asia jurisdictions, like India and Indonesia, which has high mobile phone/personal device penetration, similar demographics and a growing acceptance of electronic payment methods.

Outside of traditional M&A and technology driven JVs, we are also seeing an increase in group reorganizations through court approved portfolio transfer schemes, driven by (among other key commercial drivers) Solvency II and Solvency II equivalence regimes (like Bermuda), especially in Hong Kong for local branches of European or Bermudan insurers.

As we predicted in our 2017 *Year End Review*, Chinese outbound investment has decreased as a result of the government's restrictions on capital outflows and crackdown on outbound M&A. Chinese outbound non-financial investment fell by 40.9% in the first 10 months of 2017. This trend has been exacerbated by the Chinese government's recent announcement of a tightening of controls requiring regulatory approval for foreign acquisitions carried out through an offshore entity[1] and, until calls for looser regulation in the Chinese market are answered, we expect this to continue.

Broker consolidation. Insurance brokers have been the most active deal acquirers in the insurance market this year. Brokers have sought to consolidate their businesses pulling out of higher-risk markets and refocusing their efforts elsewhere. This trend is underlined by Aon's November sale of its stakes in employee benefit, insurance and reinsurance brokerage operations in Kenya, Lesotho, Malawi, Namibia, Uganda, and Zambia. Aon continues to operate in those countries via local correspondent arrangements. In a significant strategic move in the UK market and as a sign of the strength of opportunities still available, Aon's UK business acquired the strong brand of Henderson Insurance Brokers in Q4 2017.

The more developed markets are not immune, however, to increased regulation and pressure on margins, which has driven a number of disposals in the UK market[2], such as the merger of Lark Group and Aston Scott in June and the acquisition of Carol Nash by Ardonagh Group in October.

Buoyant Run-off Market and closed life insurance books sold. Insurers continued to dispose of their UK closed life insurance books in 2017 amid Brexit-related concerns and the fall in the value of sterling – such assets are appearing more risky and less lucrative than previously considered. This trend started in 2016 with AXA and Deutsche Bank selling their UK portfolios and has not abated in 2017. A number of strategic acquirers of run-off business, such as Athene, have been on the lookout for opportunities to take advantage of the pressure on life insurance companies that has been caused in part by low interest rates. We expect this activity to continue into 2018, and indeed Munich Re indicated in October 2017 that its primary insurance arm intended to offload up to six million policies.

The run-off market generally has remained active over the last year. Regulatory change and pressure on margins are now compounded by fears over Brexit and many industry players seeking consolidation of their businesses. A recent example is Athene Holdings' US$2.36 billion equity raise to fund investments in the German and European guaranteed life insurance run-off markets. Banks, private equity and pension funds have been more active in this space.

We have also seen significant transactions in the non-life space, including RSA's disposal of £834m in liabilities to Enstar in Q1 2017, and we expect to see further large non-life deals emerge in 2018 as market capacity frees up. In early 2017, Premia Holdings was established with a significant capital raise of US$510 million focused on the property and casualty run-off space. Deals in the run-off sector took up a greater share of the market in 2016 than in 2015 and this appears to have increased further in the last year, with little sign of slowdown.[3]

Predictions for 2018

Brexit-related reorganizations. As the post-Brexit landscape becomes clearer over the course of 2018, we expect to see insurers conducting further reorganizations of their UK and European operations.

This is likely to result in disposals, redistribution of assets and operations throughout Europe, and an increase in activity in the run-off market (as mentioned below). A number of our significant international clients are in the process of restructuring their European operations to transition into a post-Brexit environment and we expect these activities to increase significantly over the course of 2018, including new European branches being opened by UK-based insurers hedging against the risks of losing passporting rights in the event of a hard Brexit.

Continued activity in the run-off space. As mentioned earlier in this *Year End Review*, we are also expecting to see more of the capital that is being injected into dedicated run-off players to drive significant transactions in both the life and non-life space. We

1 https://www.ft.com/content/b88a3d48-d16e-3fb4-8781-1f49ae838698
2 http://www.insuranceinsider.com/-1267019/9
3 http://www.emagcloud.com/NewtonMedia/Intelligent_Insurer__RunOff_2017/index.html#/12/

have seen and are anticipating continued interest in closed life and annuities books in particular from private equity firms, as well as from large Asian insurers looking to increase their international presence.

Run-off transactions will be driven in part by the Brexit-related reorganizations referred to above, as well as by insurers' increased focus on cost base and seeking additional capital efficiencies in response to Solvency II.

In Germany, for example, low interest rates are contributing to increased market consolidation and we expect this to continue. In Italy, similar low economic growth prospects in the life insurance market will require efficient management of life books and we anticipate additional disposals. Further, in the UK, as we have already seen in 2017, we expect the specialist run-off players will continue to acquire life and annuities books and provide run-off solutions to larger insurers in relation to liabilities they no longer want to keep on their balance sheets.

InsurTech market to mature. InsurTech has been attracting ever increasing amounts of investment, from US$1.7 billion in 2016[4] to close to US$1 billion being invested in Q2 of 2017 alone[5]. As mentioned in the "Innovation and Technology in Insurance" section below, insurers are looking increasingly to InsurTech in a drive to keep up with customers' demands for innovation. With greater regulatory familiarity with the sector, as well as encouraging moves by the regulators to increase innovation in the sector (see our commentary in the "The Global Regulatory Experimentation: Regulatory Sandboxes" section below), we expect to see InsurTech entering a more mature stage in its sector lifespan. Investment in the sector to date has been characterized by venture capital investment, and 2018 may see a number of these investments pay off.

We have also seen traditional insurers partnering with significant tech companies, most notably Aviva developed a "skill" for Amazon's Echo device. Now Alexa can answer questions about insurance and insurance jargon. This is one sign of the maturation of insurers' approach to the InsurTech scene, in particular the opportunity to increase brand presence and customer contact points through non-traditional channels, and we believe that insurers will be seeking out further opportunities for collaboration and technological growth, whether through partnerships, joint ventures or ultimately acquisitions. As well as at the lower end, with InsurTech becoming more strategically important to key players, we expect to see more valuable M&A activity in this space in the coming years as early investors seek exits and acquisitions of mature businesses.

4 https://home.kpmg.com/uk/en/home/insights/2017/08/venture-capital-funding-in-insurtech.html

5 https://www.insurancejournal.com/news/international/2017/07/24/458672.htm

2017 Trends in Warranty and Indemnity Insurance

The warranty and indemnity insurance market, or representations and warranties insurance market, has gone from strength to strength in the past year and is now more than ever a common facet of M&A deals in all regions other than Asia (outside of auction processes). This specialist insurance market has grown geographically, particularly in the US, and continues to develop, with greater flexibility on policy terms and more competitive pricing. There is now a core set of specialist insurers dedicated to this market offering insurance tailored to individual M&A transactions.

Buy-side vs. Sell-side

Warranty and indemnity insurance has been around for decades as a way of facilitating risk transfer in M&A transactions. However, the structure has indeed changed. In recent years, there has been a clear move away from the traditional sell-side policy, where the seller, as the insured entity, is insured for loss arising out of a (successful) breach of warranty claim brought by the buyer.

Based on our 2017 M&A global intelligence report, buy-side policies dominated the 2017 market, with sellers using them to achieve a "clean exit" on both auctions and non-auctions, while offering an appropriate level of post-closing protection for the buyer. Such a clean exit is difficult to achieve for sell-side policies, where the seller typically has to accept a high contractual cap on liability in the SPA. This is further supported by AIG's "M&A insurance comes of age" report, with the finding that fewer sell-side policies are taken out as buyers have become more comfortable with insurance and are more willing to rely on it, as opposed to direct recourse against the seller. Even more attractive to a seller is that insurers are increasingly willing to underwrite buy-side policies where the sellers have zero risk.

Unsurprisingly, the move from buy-side to sell-side has been driven primarily by private equity and other financial investors, where achieving a clean exit is a top priority.

Making a Difference in a Competitive Market

Buy-side policies are typically seen in deals starting around the £25 million mark, when the deal size can more readily carry the insurance premium. However, policies have been placed on deals worth in excess of £1 billion with excess layers of insurance, evidence of the competition in the market continuing to grow and insurers becoming more comfortable with these risks, presumably partly due to their own improved in-house legal expertise. According to research carried out by brokerage firm Lockton, premiums and deductibles continued to drop in 2017 while coverage positions are being enhanced as insurers aim to differentiate themselves from the competition.

Brexit Impact (or Lack Thereof)

Saving the best for last – what about Brexit? Despite the UK's decision to the leave the EU causing (to put it lightly) quite a stir in the insurance market, warranty and indemnity insurance is one area where Brexit has had little impact, there seemingly being no significant decline in the number of enquiries or policies being purchased for UK deals (based on the Marsh transactional risk report 2017). However, in light of Brexit and other economic headwinds, the mix of target businesses being shown to the market has shifted with a greater interest in financial technology, healthcare and renewables and so we may see the knock-on-effect of this in the warranty and indemnity market in the year to come.

Tax Updates

Federal Tax Reform

Both chambers of the US Congress passed their own drafts of tax reform legislation at the end of 2017[6]. On December 15, 2017, Congress released its final compromise tax package, The Tax Cuts and Jobs Act of 2017 (TCJA). On December 22, 2017, the President signed the TCJA into law. In addition to the general changes affecting corporations (for example, elimination of the alternative minimum tax, the reduction in top rate from 35 percent to 21 percent, the availability of net operating losses (NOLs) and the deductibility of interest expense), the Act modifies a number of provisions of the Internal Revenue Code affecting domestic insurance companies and the contracts they write. Many of these changes will necessitate Treasury's promulgation of regulations and/or technical corrections by the Congress.

The following summary highlights some of these changes:

Prevention of Base Erosion

The TCJA requires "applicable taxpayers" to pay the excess of 10 percent (5 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 (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.
- Applicable taxpayers include corporations 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" (aggregate amount of base erosion tax benefits for the taxable year divided by the aggregate amount of deductions for such year) of at least 3 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 certain existing tax law attribution rules; or (iii) it is related to the taxpayer under the transfer pricing rules.

Insurance and reinsurance groups that engage in significant off-shore affiliate reinsurance arrangements will need to assess the structure of such arrangements to determine whether to continue such arrangements in their current form, including considering the possibility of establishing a Section 953(d) reinsurer if the nontax benefits warrant the continuation of such arrangements.

6 The House bill was passed on November 16, 2017, while the Senate bill was passed on December 2, 2017.

Controlled Foreign Corporation (CFC) Rules

The TCJA modifies to the definition of "US shareholder" for CFC purposes, expanding the definition to include US persons owning 10 percent or more of the value of the CFC's shares (pre-TCJA law only looked to voting power). The TCJA also expanded constructive ownership rules for stock, causing foreign subsidiaries in a foreign-parented group that includes a US subsidiary to be treated as CFCs. Finally, under the TCJA, a US shareholder is subject to current US tax on a CFC's subpart F income even if the US parent does not own stock in the CFC for an uninterrupted period of 30 days or more during the year.

Changes to Passive Foreign Investment Company Tax Treatment

US investors in non-US corporations may face draconian anti-deferral rules if such a corporation is classified as a passive foreign investment company (PFIC) for US federal income tax purposes. An exception to the PFIC rules applies to active insurance or reinsurance companies. The TCJA narrows this exception, tracking prior legislative proposals aimed at addressing a perceived abuse whereby some insurance activities were used to shelter large investments. The TCJA may, however, unintentionally, ensnare offshore reinsurers that reinsure long-tail and catastrophic risks where significant reserves for losses are not recorded until a catastrophic event actually occurs as well as life reinsurers that provide insurance on a modified coinsurance basis.

A PFIC is any foreign corporation if (1) 75 percent or more of its gross income is passive income or (2) at least 50 percent of its assets produce passive income.[7] In general, passive income is any income which is of a kind that would be foreign personal holding company income as defined in Section 954(c).[8] Under pre-2018 law, however, passive income did not include any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation (Insurance Business Exception).

The TCJA narrows the Insurance Business Exception for tax years beginning after December 31, 2017, by replacing the pre-2018 law test, which is based on whether a corporation is predominantly engaged in an insurance business, with a new test based on the corporation's insurance liabilities (New Test). As with the pre-2018 law test, the New Test requires that the corporation seeking to take advantage of the Insurance Business Exception would be subject to tax under subchapter L if it were a domestic corporation. In contrast to the pre-2018 law test, however, the New Test does not require that at least 50 percent of the corporation's assets produce passive income. Instead, the New Test requires that the corporation's "applicable insurance liabilities" constitute more than 25 percent of its total assets as reported on its "applicable financial statement" for the year ending with or within the taxable year.

Applicable insurance liabilities mean, with respect to any property and casualty or life insurance business, (1) loss and loss adjustment expenses and (2) 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. Applicable insurance liabilities thus include loss reserves for property and casualty, life, and health insurance contracts and annuity contracts, but not unearned premium reserves with respect to any type of risk. For purposes of the New Test, the amount of any applicable insurance liability may not exceed the lesser of such amount (1) as reported to the applicable insurance regulatory body in the applicable financial statement (or, if less, the amount required by applicable law or regulation) or (2) as determined under regulations prescribed by the Treasury Secretary.

If a corporation fails to qualify solely because its applicable insurance liabilities constitute 25 percent or less of its total assets, a mitigation provision allows a US person who owns stock of the corporation may elect in such manner as the Secretary prescribes to treat the stock as stock of a qualifying insurance corporation if (1) the corporation's applicable insurance liabilities constitute at least 10 percent of its total assets, and (2) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business, and its failure to qualify under the 25 percent threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.

Facts and circumstances that tend to show the firm may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood and large potential costs; workers focused to a greater degree on investment activities than underwriting activities; and low loss exposure. Additional relevant facts for determining whether the firm is predominantly engaged in an insurance business include claims payment patterns for the current and prior years; the firm's loss exposure as calculated for a regulator such as the SEC or for a rating agency, or if those are not calculated, for internal pricing purposes; the percentage of gross receipts constituting premiums for the current and prior years; and the number and size of insurance contracts issued or taken on through reinsurance by the firm. The fact that a firm has been holding itself out as an insurer for a long period is not determinative either way. Runoff-related or rating-related circumstances include, for example, the fact that the company is in runoff, that is, it is not taking on new insurance business (and

7 I.R.C. § 1297(a).

8 I.R.C. § 1297(b)(1). Foreign personal holding company income includes dividends, interest, rents, royalties and capital gains.

consequently has little or no premium income), and is using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books. Such circumstances also include, for example, the application to the company of specific requirements with respect to capital and surplus relating to insurance liabilities imposed by a rating agency as a condition of obtaining a rating necessary to write new insurance business for the current year.

Modification of NOL Deduction

Pre-TCJA, life insurance companies were subject to special rules on the deductibility of NOLs.[9] The TCJA repeals these rules and subjects life insurance company NOLs (arising in tax years beginning after December 31, 2017) to the same treatment as other non-insurance corporations; these rules disallow carrybacks and permit indefinite carryforwards (though limited to 80 percent of taxable income). With respect to property and casualty insurers, the TCJA preserves the pre-TCJA NOL regime applicable to property and casualty insurers, which provides a two-year carryback and 20-year carryforward for NOLs.

Repeal of the Small Life Insurance Company Deduction

Pre-TCJA, small life insurance companies were able to deduct 60 percent of their tentative life insurance company taxable income. The TCJA repeals this provision, effective for tax years beginning after December 31, 2017.

Adjustment for Change in Computing Reserves

A change in the method of computing reserves may require income inclusions or deductions. Pre-TCJA, these items of income or deduction were required to be spread ratably over a 10-year period starting the taxable year after which the change takes place. The TCJA repeals the special 10-year period in favor the general rule for tax accounting method adjustments, which requires an adjustment to be includable ratably over a four-year period. The provision applies to taxable years beginning after December 31, 2017.

Repeal of Special Rule for Distribution to Shareholders from pre-1984 Policyholders Surplus Accounts

Pre-TCJA, amounts held in a life insurance company's pre-1984 policyholder surplus account were untaxed unless treated as distributed to shareholders or subtracted from the policyholder surplus account. The TCJA repeals this special rule and requires the inclusion in income of amounts from pre-1984 policyholders surplus accounts ratably over an 8-year period starting in 2018. Life insurance company losses are not allowed to offset the amount of the policyholders surplus account balance subject to tax.

Modification of Proration Rules for Property and Casualty Insurance Companies

To reflect the lowered corporate tax rate, the TCJA modified the proration rules replacing the 15 percent reduction under pre-TCJA law with a reduction equal to 5.25 percent divided by the top corporate tax rate. For 2018 the top corporate tax rate is 21 percent, so the percentage reduction for property and casualty companies is 25 percent. The provision would be effective for tax years beginning after 2017.

Modification of Discounting Rules for Property and Casualty Companies

The TCJA requires property and casualty insurance companies to use a higher rate (the 60-month average corporate bond yield curve, as specified by Treasury) to discount their unpaid losses instead of using the applicable mid-term federal rate. Additionally, property and casualty insurers may no longer elect to use company-specific, rather than industry-wide, historical loss payment patterns. Ten-year lines will be discounted over a maximum of 25 years; and 4 years for 2-year lines. The provision generally would be effective for tax years beginning after 2017, with a transition rule that would spread adjustments relating to pre-effective date losses and expenses over eight years.

Modification of Computational Rules for Life Insurance Tax Reserves

The TCJA modifies the computation of life insurance reserves to limit the amount of the life insurance reserves for a contract (other than certain variable contracts) to the greater of the net surrender value of the contract or 92.81 percent of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined. An eight-year spread of the difference in reserves as of December 31, 2017, resulting from the modification is permitted.

Capitalization of Certain Policy Acquisition Expenses

Pre-TCJA law provided for the capitalization of specified policy acquisition expenses over a 120-month period, beginning with the first month in the second half of the taxable year based on certain percentages of net premiums, depending on the nature of the insurance contract. The TCJA increases the capitalization period to 180 months and increases the percentage of net premiums for each type of insurance contract.

9 Previously, life insurance companies carried back loss deductions three years and forward fifteen.

Tax Reporting for Life Settlement Transactions' Exception to Transfer for Value Rules

Amounts received under a life insurance contract paid by reason of the death of the insured generally are excludable from gross income. If a life insurance contract is sold or transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited. This exception to the transfer for value rules does not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income. This rule is effective for transfers occurring after December 31, 2017. Additionally, the TCJA imposes new reporting requirements (i) in the case of the purchase of an existing life insurance contract in a reportable policy sale and (ii) on the payor in the case of the payment of reportable death benefits. These reporting requirements are effective for sales and payments after December 31, 2017.

Clarification of Tax Basis of Life Insurance Contracts

Pre-TCJA, it was not entirely clear whether the contract holder's basis can be adjusted for mortality, expense or other reasonable changes incurred under an annuity or life insurance contract. The TCJA clarifies that no adjustments to basis are made for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract. The provision is effective for transactions entered into after August 25, 2009.

Antitrust Issues

As in many other areas, 2017 was a transition year for antitrust issues affecting the US insurance industry. The Trump Administration has been slow to make political appointments at the helm of each of the Federal Trade Commission and the Antitrust Division of the Justice Department, and, to the extent that it has done so, signs of a precise regulatory policy have been elusive. The beginning of 2017 thus saw the dramatic conclusion of efforts begun during the Obama presidency and, by the end of the year, a few significant matters have been commenced by the Trump Administration in a number of industries. As with most past political transitions, the work of the investigative career staff at each of the antitrust agencies is unlikely to change significantly, but it is too early to tell whether the new administration's political appointments will bring dramatic change at the policy level.

By mid-February 2017, prior to the appointment of new Assistant Attorney General Makan Delrahim, the Antitrust Division had obtained federal court orders blocking two health-insurer mega-mergers (Anthem/Cigna and Aetna/Humana), thus bringing to a close significant enforcement efforts of the Obama Administration. We discussed those matters in our previous year end report. Late in the year, on December 5, 2017, CVS announced its proposed acquisition of Aetna for approximately $68 billion, the year's largest corporate merger. The regulatory review of the transaction is likely to be one meaningful bellwether of the Trump Administration's antitrust policies, but as of this writing it remains difficult to tell which direction those policies may take.

Except for a relatively small potential overlap in Medicare drug benefits administration, the CVS/Aetna merger is primarily a "vertical" transaction, in that it generally involves the combination of businesses at different levels of the distribution chain. By and large, Aetna's health insurance, drug benefits plans, and healthcare provider networks will be combined with CVS's retail pharmacies and walk-in clinics. Traditionally, vertical mergers do not raise serious concerns with US antitrust agencies and, when they do, those concerns can frequently be resolved through conduct remedies (such as compulsory access or licensing arrangements) as opposed to structural divestitures. Contrary to this general trend, however, one of the Antitrust Division's first significant steps in 2017 under the leadership of Makan Delrahim was to file a lawsuit to block the vertical merger between AT&T and Time Warner, which is scheduled to be tried in March 2018. Mr. Delrahim has criticized conduct remedies for their tendency to turn enforcers into regulators because they require ongoing compliance monitoring. From this, one could infer a greater willingness by Mr. Delrahim to challenge outright, rather than resolve through remedies, vertical mergers like the CVS/Aetna combination. The Federal Trade Commission has not expressed similar misgivings about resolving vertical merger issues through conduct remedies; but in early January 2018, CVS announced that the transaction would be reviewed by the Antitrust Division. The Antitrust Division generally reviews mergers in the insurance industry, but the FTC is typically responsible for pharmacy mergers, as when it approved (subject to divestitures) the combination of Walgreen's and Rite Aid in September 2017.

On the business side, 2017 saw a continuing increase in corporate buyers' use of insurance policies to cover the risk of antitrust remedies being imposed on M&A deals. Underwriting such a policy generally requires not only an understanding of the substantive antitrust risk presented by the subject combination (*ie*, the likelihood that a regulator will have antitrust concerns), but also a detailed understanding of the procedures and mechanisms for the imposition of remedies, and of strategies for the advance measurement of the financial magnitude of likely remedies in order to define the policy's scope. These efforts and considerations must also be coordinated with the buyer's likely desire to avoid signaling to a reviewing agency that significant antitrust concerns may be present. As a result, M&A deals where such policies may be used have seen increasing involvement by antitrust specialists, not only on behalf of the parties, but also and importantly on behalf of third party insurers and reinsurers.

INNOVATION AND TECHNOLOGY IN INSURANCE

InsurTech/FinTech

The insurance sector is faced with a rapidly changing environment driven by technology and other innovations. Insurers launching corporate venture capital strategies are in a race to exploit digital initiatives, and are seeking to use technology to drive their business and enhance their product and service offerings. Insurers need to innovate, both to stay ahead of legacy competitors and to preempt the erosion and disruption of established business models by ambitious and nimble digital startups.

Insurance Industry Adapting to InsurTech Disruption

We reported in Q4 2016 that, while many players in the insurance sector are becoming increasingly aware of the need to focus their business strategies on digital output, the sector as a whole is still digitally immature; less than half of insurers have the mobile digital functionality to provide a quote and only 23 percent are able to submit and process claims digitally. We reported that some of the reasons behind the relative tech immaturity and subsequent sluggish digital growth in the industry compared with other business sectors were the cost of initial investment to transform legacy technology systems, fluctuating regulatory requirements and internal cultural constraints.

Despite these hurdles, we predicted in our publication last year that 2017 would see:

- increased activity and investment in InsurTech, as insurers seek to use technology to support new product offerings, improve internal operations and customer service and as disrupters continue to try and introduce game changers to the industry and
- significant further evolution in the regulatory standards and regulatory structures applicable to insurers.

Sure enough, 2017 saw the insurance industry taking the plunge into the InsurTech pool, experimenting with new InsurTech products themselves via regulator-backed innovation hubs and partnering with tech innovators via venture capital initiatives. For example Allianz (as well as Aviva and Munich Re) set up significant venture funds to invest in early stage technology companies which will keep them abreast of innovation and drive their digital strategies. In 2017, borrowing ideas from some InsurTech startups, Allianz launched AllianGo, a site that serves the small business segment operating in the business owners policy, commercial auto and workers' compensation space in a range of industries. Allianz was not alone among carriers looking to compete in the online space. Launching its own platform in 2016, Starr Companies purchased a minority stake in CoverWallet in 2017, stating its intention to work together to develop new digital-based products. MetLife also recently announced that it is starting an insurance startup training program that will offer the startups accepted up to $120,000 in seed money each for an equity stake in each startup.

On the other side, new market entrants continue to disrupt and drastically change the traditional way of purchasing insurance. The continued growth of peer-to-peer insurance and the internet of things devices provide ample opportunities for non-traditional players to enter the insurance market. In 2018, learning from the missteps of startup companies that hit regulatory or other hurdles, startup companies will continue their strategic growth and expansion. For example, California-based Hippo which launched in April 2017, announced in early 2018 that it formed a strategic partnership with Spinnaker Insurance Co. to expand its product offering into new states.

Various industry analysts consider London to be the global hub for European InsurTech investment, with 30 percent of all deals in the continent taking place in London. Landmark InsurTech deals, such as the £180 million investment in life insurance startup Gryphon, have meant that 2017 was a bumper year for InsurTech. In the first half of the year alone, £218 million was invested into InsurTech businesses, (according to an analysis of figures from venture capital tracking company CB Insights) representing a 2,695 percent increase from 2016.

Despite the surge of investment, bringing InsurTech products to market can be unpalatable given the demands of regulatory compliance. New product development in a heavily regulated environment faces uncertainty, cost, and delay of authorization and approval processes and the fact that regulation in many countries imposes consumer protection rules on the sale of insurance products which are arguably not suited to distribution in a fast-moving digital environment. Enhanced data protection and privacy laws in the form of the successor legislation to the European Data Protection Directive, the GDPR, briefly mentioned initially in the "Data Security" section above, restrict how data can be used in an industry where marketing and successful underwriting is dependent on understanding the customer's individual features, and the risk he or she represents, as further discussed below.

InsurTech companies have historically taken a more liberal approach to regulatory and data compliance, relying on the viral potential of big data economies and the fact that the tech sector is not a traditionally regulated area, to slip products into the market quickly. This means that, often, when larger companies acquire InsurTech innovators without a regulator-friendly tried and tested product, their concerns can be that they are acquiring an unruly teenager with no respect for regulatory boundaries. Bringing such innovators under the auspices of parental and regulatory guidance requires significant outlay to make sure they are fit for purpose in a regulated environment. If they are not, the financial penalties can be high, and the reputational implications potentially much higher.

To balance the need to encourage innovative new products with ensuring that they are implemented in a safe and compliant manner, regulators in certain jurisdictions have taken steps to provide a platform to road-test InsurTech innovation in a controlled environment (reported on below in relation to regulatory sandboxes).

The Global Regulatory Expermentation: Regulatory Sandboxes

We reported earlier this year that some regulators (including notably the UK's FCA, ASIC in Australia and the Singapore Monetary Authority) have encouraged innovation and international competition to attract or retain tech businesses. In the UK, the FCA has been seen as a global frontrunner in developing an innovation-friendly regulatory environment, while regulators elsewhere have shown varying levels of enthusiasm as they balance the desire for a benign supervisory environment in which to facilitate the development of InsurTech with the risks of a regulatory free-for-all.

The FCA started its promotional program "Regulatory Sandbox" at the beginning of 2015. The Sandbox was pioneered as a way for FinTech businesses to test new products under the eyes of regulatory scrutiny, without fear of being penalized if they fall short. This facilitated quick and honest feedback on both the products and on the impact of regulation on technological advancement.

In 2017, the FCA chose three InsurTech firms for its Sandbox: Wrisk, Etherisc, and Sherpa. Wrisk is a start-up that offers usage-based contents insurance products on a smart phone. Etherisc offers fully automated and decentralized flight insurance using blockchain. Sherpa offers an automated personal lines advisory broker, with no human interaction. Customers provide their details via their smartphone or computer, and Sherpa creates a customer risk profile and makes product recommendations.

The Hong Kong Insurance Authority has followed the FCA's lead, launching its InsurTech Sandbox and "Fast Track". The Sandbox allows existing authorized insurers to undergo a trial run in the Sandbox, during which they can collect data to show the Insurance Authority that the product broadly meets necessary regulatory and supervisory requirements. Fast Track is an expedited process of obtaining authorization to carry on insurance business wholly through digital distribution channels. The applicant must plan to own and operate their proprietary distribution channels, and traditional bancassurance, agency or broker channels are not allowed. Both of these initiatives are currently in their pilot phase.

Other regulators have been more cautious in their approach to InsurTech. Despite Berlin being considered by a number of industry experts as the next biggest hub for InsurTech investment behind London, Felix Hufeid, President of the German Federal Financial Supervisory Authority (BaFin) explicitly stated at the beginning of 2017 that it will not be introducing such a sandbox initiative. BaFin's stance remains that InsurTech organizations operating in an area subject to mandatory authorization must comply with the same regulations as established institutions. Therefore, they can only put their innovative business models on the market once they have obtained the necessary permissions. It is noted that BaFin's position is consistent with the fact that it has no authority to allow exceptions to the mandatory requirements of financial regulatory law and has not been authorized by the legislator to promote individual undertakings.

It is not only the German regulator that remains unconvinced by the benefits of a regulatory sandbox. A number of German FinTech representatives have voiced concerns over following the FCA's model, rejecting the notion that InsurTech products should be granted any kind of "regulatory honeymoon". More seasoned FinTech players believe that encouraging a lenient attitude toward startups could undermine public trust in the regulator and unsettle clients and investors.

NAIC's Serious Look into InsurTech Regulatory "Sandboxes" and Further Partnership with the Tech Industry

Although regulatory sandboxes have existed outside of the US for some time, state regulators have been slow to embrace the regulatory sandbox concept, which could be a tool to support innovation and technological advancements in the insurance industry. In 2017, however, the NAIC moved towards to normalizing and acceptance of such concepts. The NAIC Innovation and Technology (EX) Task Force invited the American Insurance Association and the American Family Insurance Company to make a formal presentation on regulatory sandbox concepts. The AIA additionally presented a proposed draft model law designed to allow for "sandboxes" – authorizing state insurance regulators to exercise flexibility in working with startups and incumbent insurers working on innovative products and services. Several interested parties provided comments on the issue, with commenters generally expressing that they were not opposed to "sandboxes" in principle so long as they are fair to current market participants and consumers. The concern was centered on the fact that such companies would have relaxed regulatory requirements to experiment with new business models and products that may not align with current regulatory standards imposed by other insurance and insurance related companies. Further, Independent Insurance Agents & Brokers of America said it would oppose the proposals as vesting excessive discretion in regulators to the detriment of policyholders and producers.

In 2017, the NAIC also participated in a number of InsurTech gatherings. The NAIC sponsored 25 regulators to attend *InsureTech Connect* and held a series of programs following the conference. The programs included:

- a half-day workshop where 22 regulators sat down with 20 startups to discuss business models and regulatory considerations
- a day of presentations from InsurTech startups

- an event with Google focused on public policy considerations around autonomous vehicles and
- a day-long cybersecurity conference at Stanford University.

Technology Company Entrants to Insurance

While adjusting to startup technology-based insurance disruptors, the insurance industry must prepare for the next tsunami of new market entrants – large technology disruptors. With more sophisticated data and software, as well as the integration of technology into customers' lives and the imagination that comes with the technology sector, it is extremely likely that massive technology platforms like Google, Amazon, and Facebook will play a significant role as disruptor of the industry in the near future.

There have been rumors that Amazon is opening a new division in London targeting the insurance market. A large technology company like Amazon could leverage the in-depth knowledge of its customers that it has gained over the last two decades in the insurance market. While most traditional insurers are moving toward modernizing their organizational, technical and cultural legacy systems, Amazon has already built a leading tech company that currently uses algorithms to analyze consumer behavior and has mastered the art of cross- and upselling. The popularity of products like the Alexa voice assistant may mean effortless searches for insurance policies across different providers, presenting a competitive threat to insurance brokers.

It remains to be seen how the recently announced partnership among Amazon, Berkshire Hathaway and JPMorgan Chase & Co. to reduce healthcare costs and improve satisfaction will affect their US employees as well as the broader healthcare market.

Data Security

Data security remained a hot topic in 2017 as additional large-scale cybersecurity breaches made global headlines. Regulators around the world responded with new or updated cybersecurity requirements and standards. Internationally, the FSB conducted a survey to analyze global cybersecurity regulations and practices and the UK issued guidance concerning cyber risk management. Domestically, the NAIC adopted a Data Security Model Law, modeled after New York's "first in the nation" cybersecurity final regulation applicable to all insurance industry licensees.

These efforts are discussed in further detail below.

FSB Summary Report on Financial Sector Cybersecurity Regulations, Guidance, and Supervisory Practices

On October 14, 2017, the FSB delivered a summary report and detailed analysis of the results of a stocktake on cybersecurity regulations, guidance and supervisory practices at the G20 meeting. The report came at the request of the G20 during its March 2017 meeting based on the entity's increased concern about the potential for disruption caused to financial institutions due to cyberattacks, as well as an aim to enhance cross-border cooperation. The report was informed by the responses of FSB member jurisdictions and international bodies to a survey conducted by the FSB. The summary report also set out key themes raised in an FSB workshop in September 2017 that brought together public and private sector participants to discuss cybersecurity in the financial sector.

A summary of the FSB survey concluded that all 25 member jurisdictions have been actively addressing cybersecurity in the financial sector, including the public release of regulations, guidance and supervisory practices that address cybersecurity. However, supervisory practices that are in use, but that have not been publicly released, were not covered by the G20 request or the FSB survey and were not reflected in the report.

The 10 international bodies that responded to the FSB survey suggests that jurisdictions have found existing guidance and standards to be useful and that there is some degree of international convergence in cybersecurity regulation. Private sector participants stressed the importance of a globally consistent approach necessary to avoid conflicting requirements. Participants also expressed concern about regulators' ability to protect confidential firm information, the high costs associated with cybersecurity examinations, and the need for better examiner training. Both public and private sector participants identified cross-border information sharing as a challenge that should be addressed as a part of improving overall cybersecurity.

Cyber Risk Addressed in the United Kingdom

Last year, we reported on the PRA's draft supervisory statement setting out its expectations of firms regarding cyber underwriting risks. The central expectation was that firms must be able to identify, quantify and manage such underwriting risks. In 2017, the PRA worked closely with firms across the insurance sector, focusing on the underwriting risks from both "affirmative" (*ie*, dedicated) cyber insurance policies, and other "non-affirmative" liability insurance policies that do not exclude cyber risk. The PRA found that exposure to cyber losses was almost universal among industry participants surveyed, as firms do not currently have clear strategies for managing cyber risk.

The PRA issued a new supervisory statement in light of its concern regarding cyber losses. It stated that its key expectations for all Solvency II firms in this regard fell into the following key categories:

- **Non-affirmative cyber risk.** Firms are expected to put in place measures to reduce their exposure to cyber risk. Proposed options include considering premium adjustments to reflect the nature of cyber risk and any additional/extended cover provided; the introduction of robust exclusions; and attaching specific limits of cover. If a firm decides to offer cyber cover without implementing such measures or at no additional premium, the PRA would expect to see board confirmation that a full assessment of potential resultant losses has been conducted.

- **Cyber risk strategy and risk appetite.** Cyber underwriting specifically should form part of firms' strategy and risk appetite statements. Such statements should be reviewed by the board on a regular basis (at least annually for non-affirmative policies and more regularly for affirmative policies). Management information should, at a minimum, include a clear statement of the firm's risk appetite, aggregate cyber underwriting exposure metrics and risk stress tests.
- **Cyber expertise.** Firms should understand the ever changing landscape and continue to develop knowledge of the risk. Responsibility for the risk remains with the firm regardless of any external input.

The impending implementation of the General Data Protection Regulation (GDPR) in Europe (see below for more details) poses interesting questions for cyber cover, in particular in respect of the insurability of regulatory fines which may be imposed, under the GDPR, on a policyholder which has suffered a cybersecurity breach. In the UK, the principle of *ex turpi causa* and the leading case of *Safeway v Twigger* have led most to conclude that policyholders will not be able to recover for regulatory fines imposed following a breach. However, we will not have certainty on this point until it has been tested under the new regime.

The increased frequency of large-scale cybersecurity breaches in 2017, coupled with the evolving regulatory landscape, mean that we expect to see firms looking more closely at their underwriting guidelines and risk appetite in this area, with a view to ensuring robust risk and control measures are in place to enable them to fully understand, price and assume any cyber risks going forward.

The NAIC Data Security Model Law

The National Association of Insurance Commissioners adopted the final version of its Insurance Data Security Model Law (Model Law) in October. While it will take a number of years for this Model Law to be enacted in states or adopted as a rule by the state insurance regulator depending on state law, a handful of states have already said they will submit the Model Law to their state legislatures, including Rhode Island, South Carolina and Vermont.

The Model Law has similar foundations as the New York Cybersecurity Regulation issued by the New York Department of Financial Services in that both require a company to adopt a security program based upon the company's risk assessment, which is the responsibility of and overseen by the board of directors. The security program must have appropriate administrative, technical, and physical protections of information systems and nonpublic information, protect against unauthorized access or use of nonpublic information, and include a data retention and destruction policy. NAIC intends that any insurer in compliance with the NYDFS Cybersecurity Regulation will be in compliance with the Model Law, although this is not an explicit exception in the text of the Model Law.

The Model Law allows for a tailored approach based upon the nature and scope of a licensee's activities, including its use of third party service providers, the sensitivity of the information under the licensee's control, in addition to the licensee's risk assessment. A licensee is required to submit an information security program certification to its state insurance regulator on an annual basis, report on any cybersecurity events, and retain information security related records for five years.

The Model Law also includes requirements for a licensee to investigate cybersecurity events and report events to the state insurance commissioner that have a reasonable likelihood of harming a consumer residing in the state. The Model Law formalizes a requirement to stay informed of emerging threats and vulnerabilities. Licensees should also provide employees with cybersecurity awareness training and require third party service providers to implement appropriate protections for information systems and nonpublic information.

There is a chance that NAIC may elect to make the Model Law an accreditation standard, which would require all states, DC and the territories to adopt the Model Law after a certain period of time. The accreditation process can typically take three months to one year (which includes public comment periods and determining the criteria for meeting the accreditation standard). Once adopted as an accreditation standard, there is one additional year of exposure for public comment and then states have at least four years to adopt a model law to meet the accreditation deadline. At this juncture, we have not seen strong indications that NAIC will take this approach on the Model Law and instead is likely to allow for state-by-state adoption and implementation, keeping in place the current diverse range of sector information security and data breach notice obligations.

State Cybersecurity and Data Breach Notice Requirements

In 2017, New York issued its long anticipated cybersecurity final rule, which went into effect on March 1. After multiple hearings and rounds of proposals, it was the most specific cybersecurity regulation in the country to apply to all companies licensed by the NYDFS that were not critical infrastructure operators. The NYDFS issued FAQs and a timeline of key deadlines through March 2019 to assist industry's compliance with the rule. The FAQs addressed the types of entities that fall within the scope of the rule, the notice requirements triggered by a Cybersecurity Event, the annual certification requirement, and other technical elements of the rule. Notably, New York clarified that the annual certification is only acceptable in full (rather than partial) compliance of the rule.

Upcoming NYDFS Cybersecurity Rule Deadlines

- **February 15, 2018:** All "Covered Entities" are required to submit their first annual certifications
- **March 1, 2018:** CISO reporting to the board of directors (500.04(b)), Penetration testing and vulnerability assessments (500.05), Risk assessments (500.09), Multi-factor authentication (500.12), and Cybersecurity awareness training (500.14(a)(2))
- **September 3, 2018:** Audit trails (500.06), Application security (500.08), Data retention (500.13), Policies and procedures to monitor the activity of authorized users (500.14(a)(1)), and Encryption (500.15)
- **March 1, 2019:** Third party service provider security policy (500.11)

The New York cybersecurity rule and the NYDFS guidance regarding compliance and scope must be continuously monitored in 2018. In 2017, the NYDFS, through its FAQs, expanded its scope to include branches of foreign insurance companies and banks. After the widely-publicized Equifax breach, the NYDFS issued a new proposed rule to include all consumer credit reporting agencies in the cybersecurity rule framework – expanding its scope 10 days after the massive breach was made public. In 2017, the NYDFS demonstrated its ability to be nimble, but has used its powers to expand the scope of the cybersecurity rule. To the extent there are more large scale cybersecurity breaches in 2018, we expect the NYDFS to widen the scope of its authority to regulate the cybersecurity programs of companies that do not clearly fall within the scope of the final rule.

In 2017, Connecticut, Arkansas, Delaware, Maryland, New Mexico Tennessee and Virginia amended their data breach notification laws. The states expanded the types of data breach that trigger a notification; expanded the types of companies required to provide a notification; and/or set timelines in which a company must notify specific government agencies and/or customers of a data breach. Much more activity is very likely this year in the wake of several highly publicized breaches that came to light in the second half of 2017.

Big Data

The NAIC Shifts Focus to Regulatory Review Standard-setting Versus Restricting Use of Big Data

Reflecting the Big Data (EX) Working Group's updated charges, the Working Group moved forward with the following three key initiatives in 2017:

- review of regulatory frameworks for the oversight of insurers' use of consumer data
- data tools and models used by regulators to monitor the marketplace and
- review of structures to facilitate regulatory review of big data use in underwriting and other insurance related processes (*ie*, statutory authority, speed to market models).

By the end of 2017, the Big Data Working group developed a list of regulatory issues related to the use of consumer and non-insurance data (*ie*, data not historically used or rooted in insurance underwriting). The list included a variety of issues raised by consumers, industry, and regulators. The list of regulatory issues was not completed, as it was open for public comment until January 12, 2018. The group also conducted a survey regarding whether states currently have specific prohibitions regarding the use of certain data elements used in underwriting and rating private passenger automobile insurance and homeowners insurance. This survey is expected to expand to address life insurance products in the future. Finally, the Big Data Working Group reported work behind the scenes on analyzing the data and tools needed by regulators to monitor the use of big data to ultimately develop and propose resource-sharing mechanisms for state insurance regulators to regulate its use in underwriting and other insurance related processes.

The Big Data Working Group is poised to be active in 2018. The group is wrapping up a number of its initiatives to develop issues lists, survey state insurance laws that address such and assess the tools and competency of insurance regulators to analyze products that use big data for the purpose of strengthening insurance regulatory expertise in the area. The Big Data Working Group will start issuing recommendations of modifications to model laws and/or regulations regarding marketing, rating, underwriting and claims, regulation of data vendors and brokers, regulatory reporting requirements, and consumer disclosure requirements. Depending on the extent of the final findings and proposed modifications, there is a possibility that wholesale new model laws or regulations may come out of the Big Data Working Group in 2018.

As an example, by the end of 2017, the Casualty Actuarial and Statistical (C) Task Force requested that the Big Data Working Group add an additional charge to draft potential changes to the Product Filing Examiners Handbook to address best practices for the regulatory review of predictive analytics and models used by insurance companies to justify rates as well as increase and standardize training of regulators and NAIC staff (and identify products to assist) in analyzing predictive models.

We expect a lot of continued activity in the regulation of the use of big data in underwriting and other insurance related processes as the Big Data Working Group begins to take concrete actions to accomplish goals set forth in the NAIC Work Plan.

Digitalization and Big Data – the European Perspective

Insurance companies are increasingly maximizing their digital strategies in order to stay ahead of competition and achieve sustainable success. However, expanding their big data capabilities uncover a new and demanding legislative landscape. Within the EU, the legal framework governing the processing of personal data is undergoing its biggest change in a generation, with the introduction of the GDPR. This will present challenges to big data operations and the digitalization and innovation demanded of the insurance industry by consumers. For example, the GDPR requires that data controllers (including insurance firms) use personal data only for the "specified, explicit and legitimate purposes" for which it was collected, and requires that personal data must be "adequate, relevant and not excessive" in relation to the purposes for which they are collected. In contrast, organizations looking to make best use of big data will want to collect the broadest amount of information about a subject or group of subjects from the widest range of sources, and the performance of big data analytics (for example in developing or refining home insurance products based on customer type) will necessarily involve the re-purposing of data originally collected for other reasons. Additional challenges posed by GDPR include the substantially increased transparency obligations to inform all participants in the insurance lifecycle about how their personal data is used, and the extended range of rights afforded to those data subjects to access, amend, restrict and in some cases compel the erasure of their data (the so-called "right to be forgotten").

It is not all bad news though. We predict that the increased complexities in the regulatory landscape will incentivize insurers to explore new technologies and products that enable big data usage within the new regulatory parameters. This further opens up the lines of communication between insurers and tech innovators, encouraging even more investment in InsurTech in order to drive big data strategies. In addition, complying with these strengthened regulatory standards also has the potential to enhance the customer experience through more relevant engagement and increased transparency, engendering increased trust in a society which is increasingly alert to issues of privacy and data protection.

Blockchain and Other Decentralized Technology

The Insurance Industry Demystifies Blockchain

Each year seems to have its buzzword. Although not a new term, "blockchain" was on the industry's mind in 2017, if not at the tip of everyone's tongue. In fact, voicing the term "blockchain" in the halls of conference networking events might have resulted in looks of excitement, interest, fear, or perhaps disengaged skepticism. Blockchain, however, is gaining momentum and serious consideration for utilization in (re)insurance markets.

Blockchain, in its simplest description, is a form of decentralized tamper-proof distributed ledger technology. While the ledger is simultaneously communicated publicly to all participants, security is provided via cryptography. Blockchain is based on a system or network that effectively self-verifies transactions that are then recorded in "blocks" as the transactions are completed and confirmed chronologically. This structure results in participants having access to the same, immutable data. In other words, the process can be securely and effectively applied so that large numbers of participants may access the same recorded data in respect of all transactions to date in a given market space with accuracy and confidence. To put it still another way, everyone can be on the same page.

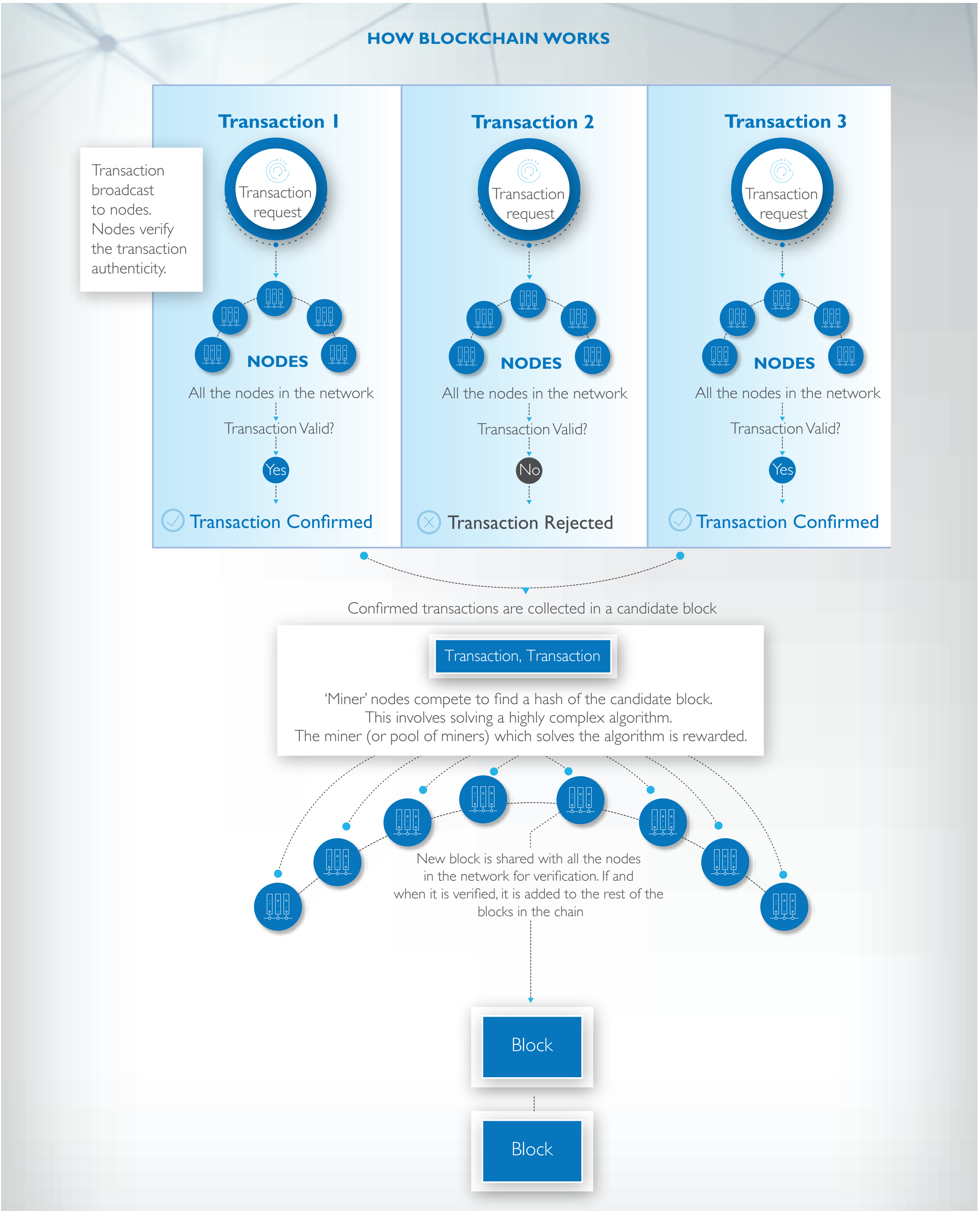
Blockchain and distributed ledger technology offers significant and scalable processing power, high accuracy rates, and high levels of security at a significantly reduced cost compared to the traditional systems the technology could replace, such as contracts, tracking and record keeping. The most visible current use of blockchain technology is to run the Bitcoin cryptocurrency, but blockchain technology can form the basis for "smart contracts," which could be particularly important for the insurance industry. The Harvard Business Review noted in a 2017 article: "For an industry that invented the concept of mutualizing and coopetition, insurance can gain enormously from the foundational technology of blockchain. Failure to act may consign many large players to the continuing trust deficit or, worse, irrelevance." A group of major insurance and reinsurance companies, including Aegon, Allianz, Munich Re, Swiss Re and Zurich, launched the Blockchain Insurance Industry Initiative, B3i, in 2016 to explore the potential of distributed ledger technologies in the insurance industry. The group of participants increased in 2017, and market testing with a developed prototype is proceeding. While the technology is being utilized in certain industry segments already to gain in efficiencies, 2018 may see a broader adoption of the distributed ledger technology, assuming testing leads to satisfactory results.

Smart Contracts – the New Horizon of the Blockchain Network

The phrase "smart contracts" was coined by computer scientist Nick Szabo in 1995, to describe what he calls the "highly evolved" practice of using "computerized transaction protocol that executes the terms of a contract." In essence, a smart contract is software code that automates the execution and enforcement of obligations in commercial transactions.

The applications of blockchain-based smart contracts can assist insurance companies in a number of areas such as managing complex pools of risks in property and casualty and industrial verticals which are usually shared by multiple parties, implementation of parametric risk insurance and the processing of claims and payment more generally. In particular, insurance companies are considering the automation of policy underwriting and handling customer's claims for claims that have clear parameters: smart contracts provide a reliable and transparent mechanism to fairly handle claims in accordance to contract-specific rules.

Blockchain technology and smart contracts offer a significant opportunity for the insurance industry to develop new insurance products and more efficient processes for providing existing products. This opportunity should assist insurance companies to address two of their major challenges: limited growth in mature markets and the pressure to reduce costs.


HOW BLOCKCHAIN WORKS
Transaction 1
Transaction 2
Transaction 3
Transaction broadcast to nodes. Nodes verify the transaction authenticity.
Transaction request
Transaction request
Transaction request
NODES
NODES
NODES
All the nodes in the network
All the nodes in the network
All the nodes in the network
Transaction Valid?
Transaction Valid?
Transaction Valid?
Yes
No
Yes
Transaction Confirmed
Transaction Rejected
Transaction Confirmed
Confirmed transactions are collected in a candidate block
Transaction, Transaction
'Miner' nodes compete to find a hash of the candidate block.
This involves solving a highly complex algorithm.
The miner (or pool of miners) which solves the algorithm is rewarded.
New block is shared with all the nodes in the network for verification. If and when it is verified, it is added to the rest of the blocks in the chain
Block
Block

THE INTERNATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

The IAIS has continued to work on multiple work streams as reported below. It also has a new Secretary General, reorganized some committees and new member regulators are seeking to establish a five-year strategic plan.

The Saga of ICS – The Push for Global Capital Standards

The International Association of Insurance Supervisors continued its push to develop an International Capital Standard (ICS), with an important agreement occurring in November 2017 regarding what the IAIS characterized in a press release as a "unified path to convergence of group capital standards."

The ICS, as defined by the IAIS, is intended to be a risk-based global insurance capital standard for internationally active insurance groups. The ICS is intended to be a single common methodology that achieves comparable (*ie*, substantially the same) outcomes across jurisdictions.

The year began with the IAIS continuing to assess the results of its initial rounds of field testing, which led to the release in July 2017 of "ICS Version 1.0 for Extended Field Testing."

In releasing this version of the ICS, the IAIS made clear that it was deliberately not addressing many of the objections stakeholders have expressed regarding the political challenges that the IAIS will surely face in trying to persuade its members to adopt the ICS as currently proposed. Instead, the version maintained many of the features of the ICS that have been previously exposed and criticized by many, such as the use of a new valuation system (referred to by the IAIS as Market-Adjusted Valuation or MAV), a prescribed Margin Over Current Estimate, and qualifying capital resource rules that exclude senior debt and surplus notes.

Moreover, the IAIS reiterated its commitment to its previously established timetable which many have argued is way too ambitious to be realistic. Under this time frame, after field testing the current ICS version, the IAIS will release Version 2.0 of the ICS in the summer of 2018. This will be followed by another round of field testing and then the adoption of the ICS as part of ComFrame at the IAIS's 2019 annual meeting. In pursuing this agenda, the IAIS had showed no interest in accommodating the development of an aggregated approach to assessing group capital needs such as those being developed by the NAIC and the US Federal Reserve as an alternative to the approaches already in ICS Version 1.0.

That position changed at the IAIS's 2017 Annual Meeting in Kuala Lumpur in November, with an announcement that instead of adopting the ICS for implementation in 2019, the implementation of ICS Version 2.0 will be conducted in two phases.

The first phase is a five-year "monitoring period" beginning in 2020 in which a "reference ICS" will be used for confidential reporting to group-wide supervisors, but the ICS will not be used as a basis to trigger supervisory action.

However, during the monitoring period, the IAIS will also collect data from interested jurisdictions relevant to the development of the aggregation method. To many US supervisors and interested parties this concession by the IAIS was viewed as a major step forward as it constitutes the first time many IAIS members have been willing to acknowledge the aggregated approach might be a viable alternative to the methodology contained in the current ICS.

The second phase of the ICS implementation, scheduled to occur now in 2025, will be the implementation of the ICS for supervisory purposes (*ie*, as a "Prescribed Capital Requirement"). It remains to be seen whether the aggregated approach will be accepted at that time, as some observers are skeptical that the IAIS staff who have been working on the ICS are open-minded about the aggregated capital approach and whether it could ever provide the "comparable" result that the IAIS insists is the essential element of any ICS.

It also remains to be seen how many internationally active insurance groups decide to voluntarily participate in the "monitoring period" exercise given the cost and time commitment that will require and the limits on what regulators could do to pressure participation in the absence of a legal requirement.

It is also subject to doubt as to whether the Kuala Lumpur Agreement really changes anything that was not going to occur, inevitably, because as a practical matter, jurisdictions around the world would not have been ready to start accepting the ICS as a formal legal standard beginning in 2020. Indeed, the ICS in all likelihood will not be ready for that in any case. Moreover, the sheer political impact of the US going ahead and developing its aggregation approach would have been a factor the IAIS could not have simply ignored in trying to get other countries to adopt the ICS.

ComFrame and the ICPs

The IAIS continued its work on ComFrame and the Insurance Core Principles (ICPs), while shifting directions; and developing new initiatives such as an activities-based approach to systemic risk, triggering the NAIC to develop its own ABA standard. The IAIS activities that directly impact the US regulatory systems are discussed below.

Throughout 2017 the IAIS worked on revising and modernizing many of its ICPs. The ICPs are important to the IAIS because, in its words, they "provide a globally acceptable framework for the insurance sector." On a more practical level for insurers and intermediaries, the ICPs provide the standards used by the IMF when it reviews a jurisdiction's regulatory system as part of the Financial Sector Assessment Program (FSAP). A poor FSAP result can provide the impetus for a jurisdiction to change its laws and administrative processes to conform more closely to the ICPs.

The following ICPs were the subject of consultations that were completed during 2017:

- ICP 1 (Objectives, Powers, and Responsibilities of the Supervisor)
- ICP 2 (Supervisor)
- ICP 3 (Information Sharing and Confidentiality)
- ICP 5 (Suitability of Persons)
- ICP 7 (Corporate Governance)
- ICP 9 (Supervisory Review and Reporting)
- ICP 10 (Preventive Measures, Corrective Measures and Sanctions)
- ICP 13 (Reinsurance and Risk Transfer)
- ICP 18 (Intermediaries)
- ICP 19 (Conduct of Business)
- ICP 24 (Macro-prudential Surveillance and Insurance Supervision)
- ICP 25 (Supervisory Cooperation and Coordination)
- Open consultations initiated in 2017, with comments due in February 2018, address the following ICPs:
- ICP 8 (Risk Management and Internal Controls)
- ICP 15 (Investments)
- ICP 16 (Enterprise Risk Management for Solvency Purposes)

Additional consultations are planned in 2018 regarding ICP 6 (Changes in Control and Portfolio Transfers) and ICP 22 (Anti-money Laundering and Combatting the Financing of Terrorism).

A key feature of these consultations is that the revised ICPs incorporate text which applies only to IAIGs as part of the IAIS's ComFrame project. Prior to these revisions, ComFrame was a separate document from the ICPs. Indeed, in the case of several of the consultations, the sole purpose of the consultation was to incorporate ComFrame text into the ICP and not to solicit comments on the underlying ICPs at all.

For the most part, interested parties seemed generally satisfied with the revised ICPs. However, similar to the issues that arise in connection with most IAIS proposals, concerns exist regarding the extent to which the ICPs do not adhere sufficiently to the IAIS's professed goals of developing principles based standards (versus standards that are prescriptive) and proportionality. Similarly, the introduction of the ComFrame text into the ICPs raises the specter that eventually ComFrame standards will seep into the ICPs themselves.

The NAIC's Macroprudential Initiative

Closely related to the IAIS's plans to develop the ABA, the NAIC's Financial Stability Task Force announced in 2017 that it was launching a "Macroprudential Initiative" in which it will "analyze existing post-financial crisis regulatory reforms for their application in identifying macro-economic trends, including identifying possible areas of improvement or gaps."

As an initial project, the MPI will focus on liquidity issues by reviewing existing public and regulator-only data related to liquidity risk, identifying any gaps based upon regulatory needs, and proposing the universe of companies to which any recommendations may apply. A Liquidity Assessment subgroup has been formed, which is expected to develop a liquidity stress testing framework for large life insurers by the NAIC's 2018 Spring Meeting, followed by potential enhancements or disclosures to implement the framework by the 2018 Summer Meeting. The life insurers at which this project is aimed thus far have welcomed the NAIC's interest.

Property and casualty insurers' initial reactions have been somewhat more reserved. In particular, leading trade associations have expressed concern about the next topic the MPI intends to review, which is recovery and resolution.

New IAIS Direction

During 2017 the IAIS was and, for much of 2018, will be focused on continuing to develop new standards, especially regarding capital, which as noted elsewhere will be subject to further development until at least 2025. However, new IAIS Secretary General Jonathan Dixson stated in remarks he made during the NAIC's Fall 2017 meeting that the IAIS plans to move away from standard setting, because that is almost done, and into "implementation and assessment" of those standards. The IAIS has also revised its committee structure under three main working committees (*ie*, "Policy Development", "Macroprudential", and "Implementation and Assessment").

This change coincides with the development by the IAIS of a new five-year strategic plan to be adopted in 2019, taking effect in 2020. Seeking early input from stakeholders, the IAIS issued a press release in late December asking stakeholders to share their "thoughts and perspectives" on macro trends and developments that may impact the IAIS and its mission and on what strategic objectives the IAIS should pursue in light of these trends and developments.

The IAIS asks commenters to consider social, technological, economic, environmental, and political issues in formulating their thoughts.

Comments in any format are requested by February 20, 2018.

US FEDERAL UPDATE: ELECTIONS; AND LEGISLATIVE AND REGULATORY DEVELOPMENTS

What the 2017 Elections Mean for Insurance

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

There are 51 Republicans in the Senate and 49 in the Democratic caucus (including two Independents). Democrats gained 6 seats in the House; however, the Republicans still control a comfortably large majority.

Senator Mitch McConnell (R-KY) and Representative Paul Ryan (R-WI) remain Senate Majority Leader and Speaker of the House, respectively.

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

The Trump Regulatory Doctrine

President Donald Trump was sworn into office on January 20, 2017, with an aggressive agenda for his first 100 days. The President spent the year signing a number of Executive Orders to move forward with his de-regulation proposals. While many of his promises will ultimately require congressional action, the Executive Orders were nevertheless legally binding directives issued to federal administrative agencies. In his very first order, President Trump gave relevant agencies authority to grant waivers, exemptions and delays of provisions in the Affordable Care Act. His reasoning is that it would minimize the economic burden of the ACA pending congressional repeal, which did not occur in 2017.

Other Executive Orders impacting the insurance industry included:

- the Executive Order Reducing Regulation and Controlling Regulatory Costs requires the executive branch to get rid of two regulations for every new one that is put into effect, arguing it will reduce a major burden on small businesses in America. In the past few years multiple federal agencies directly or indirectly issued regulations that impact the insurance industry. With the President's agenda to repeal or reduce the burden of the Dodd-Frank Act and the ACA, some insurance regulations may be rescinded.
- the Executive Order on Core Principles for Regulating the United States Financial System sets Core Principles of financial regulation of the administration, including preventing taxpayer bailouts, rigorously analyzing regulatory impact to address systemic risk and market failures, empowering Americans to make independent financial decisions. Although the Executive Order was widely characterized as commencing a roll-back of financial regulations, including the Dodd-Frank Act and the DOL fiduciary rule, it did not have immediate impact on financial regulation and the President drafted a Presidential Memorandum addressed to the DOL regarding the fiduciary rule. The Executive Orders also directed Treasury, in consultation with the heads of the member agencies of the FSOC, to report to the President within 120 days (from February 3, 2017), and periodically thereafter, on the extent to which existing laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other government policies, as well as what actions have been taken to promote or inhibit the Core Principles. Treasury released its report on October 26, 2017 (as discussed below).

The Affordable Care Act

The Trump Administration and the Republican-led Congress continued to pursue one of the primary pillars in the party's platform – repealing and replacing the ACA. While the Congress had repeal and replace as the first priority on their agenda in 2017 under the then newly seated Trump Administration, the multiple attempts to pass repeal and replace legislation through both chambers of Congress were ultimately unsuccessful. Furthermore, the failure to pass the legislation under Republican's watch only further indicated the growing awareness that there are parts of the law that have been successful at garnering public support, while other parts remain highly unpopular, making full repeal of the ACA no longer politically viable. Although full repeal of the ACA lost significant momentum, Republicans in Congress and the Administration were ultimately able to declare a significant victory at the end of 2017 by successfully including repeal of the individual mandate penalty in the Tax Cuts and Jobs Act of 2017, which essentially revised federal law to apply a zero percentage rate penalty on those who failed to maintain health insurance coverage.

Despite the legislative failure of Congress to repeal and replace the ACA in full throughout 2017, President Trump released an Executive Order in October 2017 aimed at essentially weakening the law at some of its most critical points. Executive Order No. 13813 directed officials in HHS, the DOL, and Treasury, to make certain regulatory changes. The following sets forth those regulatory change directives and, as noted, some have had proposed regulations released to date, while others await the same action:

- Decision Regarding Continuation (or lack thereof) of Cost-Sharing Reduction (CSR) Payments to those Insurers Sponsoring Health Plan Coverage for Low-Income Americans. Bipartisan discussion is currently under way following a preliminary agreement with Senator McConnell to move two pieces of legislation to stabilize insurance markets, including legislation authorizing CSR payments to insurers
- Expansion and Qualification for use of Health Reimbursement Arrangements by Small Employers: Proposed Regulations have yet to be released
- Expansion of Short-Term Health Plans: Proposed Regulations have yet to be released

The directives set forth in Executive Order No. 13813, began impacting the health insurance markets in 2017 and will certainly continue to cause an evolution of the health insurance markets through 2018 and beyond.

The major medical market will have to withstand and adjust to sudden and arguably drastic changes on the federal level in 2018, particularly regarding CSRs.

Since August 2017, Senators Lamar Alexander (R-TN) and Patty Murray (D-WA) had been working toward a bipartisan compromise to address health insurance market stabilization via authorization of funding for an additional two years for CSR payments to insurers, however, this legislation failed to move through Congress by the end of 2017. Since then, Senator Susan Collins (R-ME) has reached a preliminary agreement with Senator McConnell to make good on the GOP's 2017 promise to shore up and secure health insurance markets by promising to pass two specific bills by the end of 2018.

The two pieces of legislation encompassing the Collins-McConnell agreement would include the aforementioned Alexander-Murray legislation that would formally authorize federal CSR payments to insurers. The second piece of legislation in this agreement is sponsored by Senator Collins, and would include $5.5 billion in federal funding for 2018 – 2020 to help states set up a reinsurance or high-risk pool mechanism for older, sicker individuals to mitigate the premium increases that otherwise would be seen across the board as a result of more costly beneficiaries.

According to Senator Collins, her goal is to ensure this legislation is passed successfully through Congress and signed into law in advance of the deadline later this year by which time insurers must set their 2019 health insurance premium rates. The growing comfort among lawmakers on both sides of the aisle to ensure stable health insurance markets lends to the belief that with some discussion and compromise, these bills will pass successfully at some point this year.

Federal changes to the ACA are currently being undertaken on a piecemeal basis, but in the context of the ACA's comprehensive framework, have the potential to destabilize health insurance markets, particularly the individual market, with the outstanding question of whether any destabilization that occurs would be temporary or could deal a fatal blow to the health insurance markets.

We expect the ongoing policy and regulatory changes being contemplated through 2018 will continue to impact the evolution of the ACA and, therefore, its impact on the healthcare market, in ways that are both expected and unexpected. More specifically, it is very difficult for lawmakers and regulators alike to predict how various policy changes will ultimately translate with respect to influencing retention, or lack thereof, of healthy individuals within the health insurance risk pools; most notably, any change that leads numerous healthy individuals to exit the individual market will have amplified effects, where premium increases are concerned, which could also serve to destabilize an already fragile market.

Following the definitive failure of the 2017 effort to repeal and replace the ACA in full, it remains highly unpredictable how Republicans and Democrats with move forward on healthcare following any move to address market stabilization. What has become clear is that Republicans have heard the message loud and clear that certain portions of the ACA are wildly popular and successful, while other aspects must be addressed and corrected; however, any attempt to do so during the highly contentious 2018 mid-term election year, would be a risk neither Republicans nor Democrats are likely to take.

At this juncture, what is clear is the willingness of certain members of Congress, in both houses and on both sides of the aisle, to gain a very intimate and thorough understanding of the potential pitfalls that can be expected as the ACA continues to evolve, and how constituencies will react to that evolution. Moreover, President Trump has at times made comments that were viewed as negative toward the health insurance industry, while later walking back those comments.

Congressional and Federal Agencies Initiatives and Outlook

Department of Treasury: FSOC and FIO

On October 26, 2017, the Department of Treasury released a report that examined the regulatory framework for the asset management and insurance industries as required by President Trump's Executive Order No. 13772 (February 3, 2017), which instructed the Treasury Secretary to report to the President the extent to which the existing financial regulatory system promotes the Administration's "Core Principles" of financial regulation. The focus of the report was in four areas: the proper evaluation of systemic risk; ensuring effective regulation and government processes; rationalizing international engagement; and promoting economic growth and informed choices.

The report, identified ways to improve the regulatory framework for insurance companies, and the products and services they offer, including:

- Supporting activities-based evaluations of systemic risk in the asset management and insurance industries
- Improving coordination between the FIO and state insurance regulators
- Continuing engagement in international forums to promote the US asset management and insurance industries and the US regulatory framework
- Increasing transparency of the international standard-setting processes
- Promoting strong liquidity risk management programs for asset managers and insurance companies
- Modernizing fund shareholder reports to permit the use of implied consent for electronic disclosures
- Delaying the implementation of the DOL fiduciary rule, pending further evaluation by the DOL, the Securities and Exchange Commission, and the states and
- Promoting infrastructure investment by insurers through appropriately calibrated capital requirements.

Additionally, the report recommended different approaches to improve the efficiency of existing regulations and government processes, including:

- Realigning the role of the FIO around five pillars of focus, and improving its coordination with state insurance regulators and transparency with the insurance industry
- Reducing duplicative and inefficient oversight of savings and loan holding companies that own insurance companies, by improving coordination and collaboration between the Board of Governors of the Federal Reserve System and state insurance regulators
- Reconsidering the HUD disparate impact rule and its impact on the availability of insurance
- Adopting uniform state data security standards and breach notification requirements based of the NAIC Insurance Data Security Model Law
- Convening a federal agency-wide task force to focus on policies related to long-term care insurance
- Coordinating insurance regulations to reduce or eliminate inconsistencies between existing data calls on terrorism risk insurance and
- Improving information sharing within the insurance industry.

National Flood Insurance Program Reauthorization

In 2012, Congress passed the Biggert-Waters Flood Insurance Reform Act which reauthorized the NFIP through September 30, 2017. Despite expectations that the passage of Biggert-Waters would help shore up the fiscal condition of the NFIP and improve its administration, the Program remains in significant debt. There are many reasons the fiscal condition of the Program has remained bleak, including the impact of the 2017 catastrophic storms and the passage of the Homeowner Flood Insurance Affordability Act of 2014, which repealed many of the rate and underwriting reforms mandated by Biggert-Waters.

The NFIP was temporarily extended until January 19, 2018; however, the NFIP lapsed with Congress's failure to reach a deal to prevent the federal shutdown. On January 22, 2018, the NFIP was temporarily reauthorized again until February 8, 2018. The legislation also authorized FEMA to honor all policy-related transactions inadvertently accepted between January 20, 2018, and January 22, 2018. The NFIP had lapsed four times in its history, but Congress reauthorized it retroactively. It remains to be seen if Congress will reauthorize the NFIP for a significant period of time on February 8, 2018.

The DOL Fiduciary Rule Flatlined, but Revived

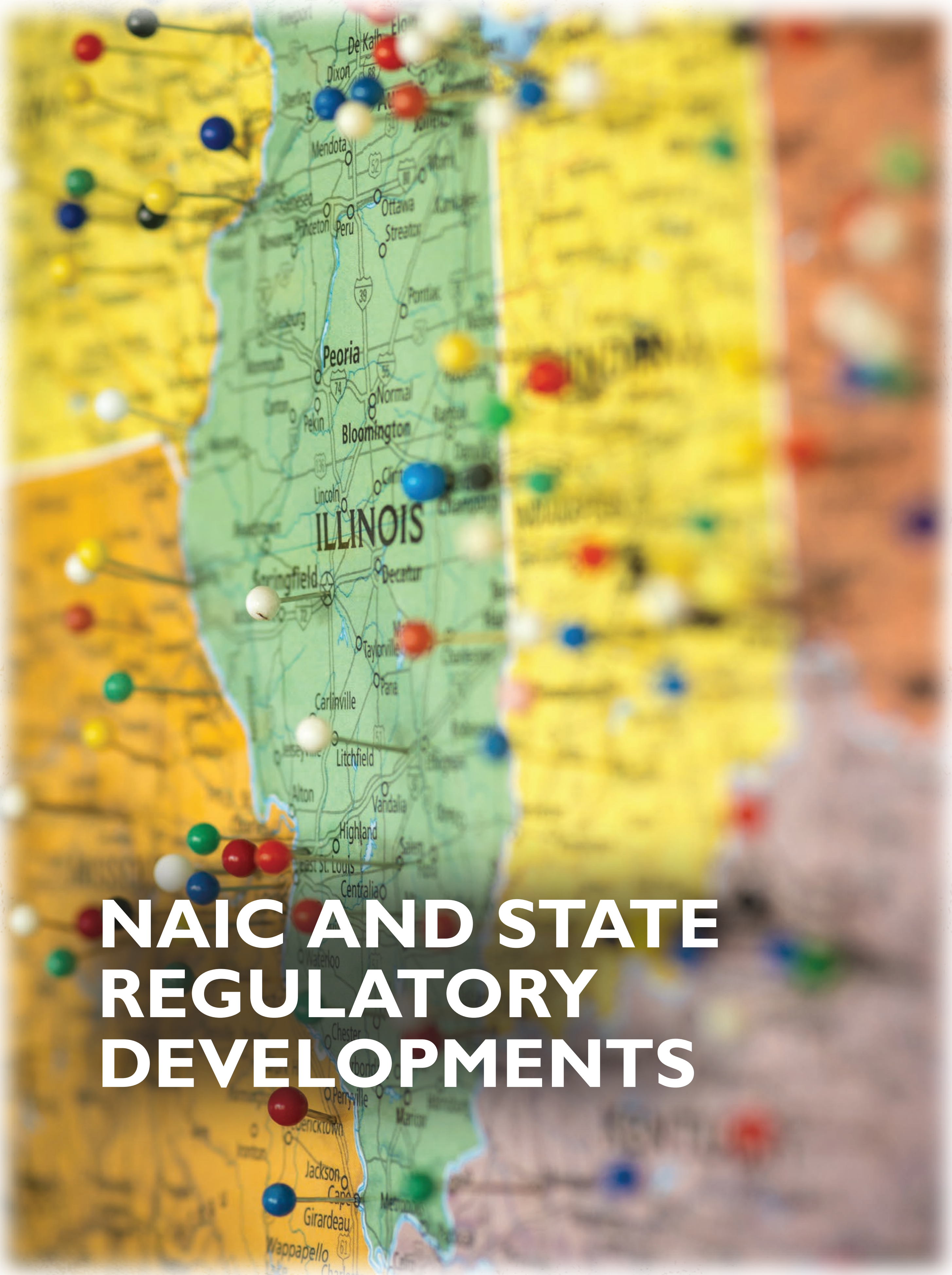
In February 2017, President Trump signed a memorandum to roll back the DOL fiduciary rule by asking the DOL to review the rule again and likely to delay its April 10, 2017, implementation. Critics contend that the DOL proposed rule would restrict access to information and education about annuities. The life insurance industry has reacted strongly against the rule and filed voluminous comments in response to the DOL rule making procedures. Their concern is that disclosure requirements and the heightened prospect of private litigation against advisors could force advisors away from marketing annuities altogether.

In May 2017, DOL Secretary Alexander Acosta announced in a Wall Street Journal op-ed that he was going to allow the fiduciary rule to take effect as planned on June 9; however, the DOL had previously announced that it would not actually enforce the rule until January 1, 2018. Only a part of the rule, which requires financial advisers to act in the best interests of their clients, took effect on June 9. By August of 2017, the DOL revealed in a court filing that it had sent the fiduciary rule to the Office of Management and Budget (*ie*, the White House) for review, which would delay full implementation of the rule (most importantly, the enforcement provisions of the rule) until July 1, 2019. The delay was formalized in a final rule issued by DOL on November 29, 2017. This delay would provide enough time for the DOL to consider additional substantive changes to the fiduciary rule prior to implementation or rescind the rule altogether.

The day after the DOL issued the final rule delaying the DOL enforcement of the fiduciary rule, SEC Chairman Jay Clayton announced that the SEC will make a fiduciary standard for brokers a priority. Nevertheless, consistent with the February 3, 2017 Executive Order and the October 26, 2017 Treasury report (both discussed above), the heads of the SEC and DOL have both pledged to work together on fiduciary rulemakings.

HUD Derails Disparate Impact Rule

In 2013, HUD issued a final rule to formalize the national standard for determining whether a housing practice violates the Fair Housing Act as the result of unlawful discrimination. The rule codifies the use of "disparate impact" analysis to prove allegations of unlawful discrimination with regards to homeowners' insurance. On June 25, 2015, the Supreme Court upheld the application of disparate impact under the Fair Housing Act in a surprise five-to-four decision. After confirmation as HUD Secretary, Dr. Ben Carson publicly opposed the use of the disparate impact theory to bridge the gaps in income and racial disparity. Additionally, the October 2017 Treasury report recommended that HUD reconsider its use of the disparate impact rule, especially the rule's application in the homeowner's insurance market. Treasury argued that the rule may violate the McCarran–Ferguson Act of 1945, in that state laws governing the business of insurance should not be "invalidated, impaired, or superseded by any federal law unless the federal law specifically relates to the business of insurance." By January of 2018, as we predicted, HUD began the process to rescind or significantly change the rule by suspending its implementation until 2020.



NAIC AND STATE REGULATORY DEVELOPMENTS

2017 State Elections, New Insurance Commissioners and NAIC Leadership

Elections in 2017 yielded few new insurance commissioners and therefore did not significantly impact the ranks of the NAIC.

Elections, Resignations and Appointments – Commissioners and the NAIC

As observers of US insurance regulation know, most commissioners are appointed by governors, so elections can change the make-up of US insurance policy-making bodies, including the NAIC. In addition, influential commissioners did not succeed in being reelected or resigned for reasons unrelated to election results. Both scenarios resulted in the following new state insurance commissioners:

- American Samoa – Peter Fuimaono, Commissioner (appointed Jan. 16, 2017)
- Colorado – Michael Conway, Interim Commissioner (selected Jan. 1, 2018)
- Delaware – Trinidad Navarro, Commissioner (elected 2016, sworn in on Jan. 3, 2017)
- Illinois – Jennifer Hammer, Director (appointed Jan. 17, 2017)
- Iowa – Doug Ommen, Commissioner (appointed Jan. 30, 2017)
- Kentucky – Nancy G. Atkins, Commissioner (appointed May 1, 2017)
- Massachusetts – Gary Anderson, Commissioner (appointed Oct. 31, 2017)
- Minnesota – Jessica Looman, Commissioner (appointed Nov. 2017)
- Missouri – Chlora Lindley-Myers, Director (appointed Mar. 6, 2017)
- Montana – Matthew Rosendale, Commissioner (elected 2016, sworn in on Jan. 2, 2017)
- New Jersey – Marlene Caride, Acting Commissioner (appointed Jan. 16, 2017)
- North Carolina – Mike Causey, Commissioner (elected 2016; sworn in on Jan. 1, 2017)
- Ohio – Jillian Froment, Director (appointed Mar. 31, 2017)
- Oregon – Cameron Smith, Acting Director (appointed Dec. 13, 2017)
- Pennsylvania – Jessica Altman, Acting Commissioner (appointed Aug. 19, 2017)
- Puerto Rico – Javier Rivera Rios, Commissioner (appointed Jan. 17, 2017)
- Texas – Kent Sullivan, Commissioner (appointed Sept. 21, 2017)
- Virginia – Scott A. White, Commissioner (assumed Jan. 1, 2018)
- West Virginia – Allan L. Mcvey, Commissioner (appointed Mar. 21, 2017)

NAIC Leadership

NAIC 2018 OFFICERS	
President	Julie Mix McPeak, Tennessee Insurance Commissioner
President-Elect	Eric A. Cioppa, Maine Superintendent of the Bureau of Insurance
Vice President	Raymond G. Farmer, South Carolina Insurance Director
Secretary – Treasurer	Gordon Ito, Hawaii Insurance Commissioner

Group Capital Calculation Tool

In 2016, the IAIS began to develop a group capital calculation (GCC) tool, which many have welcomed as a more reasonable alternative to the much criticized ICS the IAIS is working on. The GCC adopts an aggregation approach, which many in the US prefer as simpler and just as accurate as the consolidated approach used by the ICS.

The NAIC's work took on greater significance with the adoption of the Covered Agreement, given that the accompanying signing statement issued by US officials expressly provides that it is the understanding of the US that the group capital calculation tool will satisfy the conditions in Article IV(h) of the Covered Agreement that require the development of an enforceable capital assessment. This importance was further enhanced with the agreement the IAIS reached regarding the development of the ICS to specifically consider an aggregated capital approach if it is comparable to the reference ICS. Clearly, the GCC could become that alternative.

Unfortunately, to some observers, work on the development of the GCC has progressed more slowly than desirable and too much focus has been directed at relatively minor details, given that time is of the essence in light of the relationship between the development of the GCC and the Covered Agreement and the ICS.

The NAIC seems well aware of this timing concern. The 2018 charges for the working group that is developing the GCC state the GCC will be ready for field testing by the NAIC's summer meeting in July.

Given that a draft of the full GCC has still not been provided the NAIC has much work to do in 2018 on this matter.

Long-Term Care and Receivership Issues

On December 21, 2017, the NAIC amended its Life and Health Guaranty Association Model Act to address mounting concern over potential receiverships of insurers that re/insure long-term care business. The Model Act generally protects insurance policyholders against their insurer's failure to perform its policy obligations. The amendment would: (i) expand the assessment base for long-term care insurer insolvencies to include both of insurers' life and annuity account and their health account; and (ii) allocate assessments equally to life and health insurers and add health maintenance organizations as guaranty association members.

The impetus for the amendments was the conjoined multibillion-dollar receiverships of Penn Treaty and its affiliate, American Network. The NAIC acted quickly in 2017, first proposing the changes at the Spring National Meeting, but has been criticized for acting too quickly and for including HMOs and other health only insurers that do not write or hold long-term care insurance. Proponents insisted that the amendments would not become an accreditation standard, and so states could independently determine whether to adopt the amendments. It remains to be seen whether further insolvencies in the long-term care market will push the NAIC in making these amendments an accreditation standard.

EUROPEAN REGULATORY AND LEGISLATIVE DEVELOPMENTS

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European Union

Insurance Distribution Directive Implementation

The IDD entered into force on February 23, 2016, and EU member states were to have until February 23, 2018, to transpose its provisions into national law, and apply them to insurers and insurance intermediaries operating in their jurisdictions. In September 2017, Delegated Regulations supplementing IDD with regard to product oversight and governance, and the distribution of insurance-based investment products, were adopted by the European Commission. During the scrutiny period, the European Parliament noted that the industry might need more time to implement changes required to comply with the delegated regulations, and asked the Commission to adopt a legislative proposal for a delayed date of application of October 1, 2018. Sixteen member states supported the European Parliament's proposal and also requested an extension of the period for transposition into national law, until at least October 1, 2018.

On December 20, 2017, the European Commission announced that it would act on the request from the European Parliament and member states to extend the date from which IDD would be applied in member states until October 1, 2018 (although member states will still be required to transpose IDD into national law by February 23, 2018). The European Parliament and Council will now need to agree on the new application date in an accelerated legislative procedure. If this is agreed, member states will still need to have national legislation in place by February 23, 2018, but insurers and intermediaries will at least have a little more time to prepare for those laws actually coming into force.

Background

The IDD replaces the Insurance Mediation Directive and has been introduced in an effort to enhance consumer protection and to support competition among insurance distributors. As set out in our previous Reviews, notable provisions of the IDD that work toward protecting the consumer include:

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

Timeline

The IDD entered into force on February 23, 2016 and must be incorporated into national laws by EU member states by February 23, 2018. That said, in late 2017, the European Parliament's Economic and Financial Affairs Committee called for the European Commission to delay the application of the IDD until October 1, 2018. This is a recommendation that was welcomed by many of those affected, particularly in the UK and France. Indeed, in response to the second of three consultation papers published during 2017 on the implementation of the IDD in the UK (CP17/7 in March, CP17/23 in July and CP17/33 in September), many respondents expressed concern about the lack of time left for firms to implement the IDD requirements – particularly with regard to the new Insurance Product Information Document. Additionally, in France, the French Insurance Federation (in coordination with the European Insurance Federation) requested a postponement to the implementation of the IDD. Nonetheless, unless further action is taken by the European Parliament, firms affected by the IDD still need to ensure compliance with the IDD from February 23, 2018.

Implementation

The IDD is aimed at minimum harmonization, meaning that for certain areas it is at the discretion of member states to retain or introduce more stringent standards.

In the UK, the implementation of the IDD will not affect UK firms as much as firms in other EU member states as the IDD replicates many provisions currently in force in the UK, thanks to the UK's "gold-plating" of the IMD. There will, however, be further instances of going "above and beyond" in the UK in its implementation of the IDD. For example, where the IDD only requires insurance and reinsurance undertakings to establish, maintain and keep appropriate records to demonstrate compliance with knowledge and ability requirements, the FCA proposes extending this requirement to insurance intermediaries. Further, when setting out the demands and needs of a customer, the IDD does not require firms to set out which needs have not been met, yet the FCA does as it believes that including this in its rules will lead to any unmet needs being highlighted.

United Kingdom

UK Treasury Select Committee's Report on Solvency II

Less than two years after the coming into force of Solvency II, and with Brexit negotiations underway, the UK's Treasury Select Committee published its report on the impact of Solvency II on the UK Insurance Industry. The report provides a remarkably harsh assessment of many aspects of Solvency II and the manner in which the Solvency II regime has been implemented in the UK.

Treasury Select Committee's Report

The Report is an essential read for anyone interested in or impacted by the current status of UK insurance regulation, and how it may develop against the background of Brexit.

The Committee investigated Solvency II as part of its function to scrutinize the activity of HM Treasury and related public bodies, including the PRA. It received evidence from the PRA, the Association of British Insurers, and individual insurers and service providers, including AXA, Lloyd's, Prudential, PwC, KPMG, and representatives of the UK actuarial profession. The report makes stark reading for the PRA. Those who gave evidence to the Committee found fault with many aspects of the PRA's regulation of insurance and implementation of Solvency II. Their testimony has been broadly accepted, and the Committee is calling for a sea change from the PRA.

Excessive Focus on Solvency

The Committee found the PRA's approach to be overly focused on solvency, at the expense of competition, and of the competitiveness of the UK insurance industry. Although the Committee acknowledged that insurers' solvency is important, it views insurers as much less of a solvency risk than the UK banks, also regulated by the PRA (the Committee noted that there have only been two significant failures of UK insurers in the last 40 years). A central finding was that the PRA should be given a primary objective to promote competition in the UK insurance market, which should carry as much weight as its statutory objectives in relation to solvency.

Better Understanding of and Communication with the Industry

The Committee is clear that there needs to be a better and more productive dialogue between the PRA and the industry on issues like Solvency II. The Committee questioned whether the PRA has the skills necessary for effective insurance regulation, particularly at the most senior supervisory and policy levels. The PRA needed to consider whether its insurance directorate has a genuine "feel" for the insurance industry. The Committee found a disconcerting level of disconnect between the PRA's views and those of the industry. Their view was that better communication might have resolved current difficulties at an earlier stage, for example in the annuity market where issues relating to the risk margin and the matching adjustment have led some firms to exit the market, and others to reinsure significant business overseas.

Should Solvency II be Scrapped for the UK, or Improved?

The Committee has a pretty skeptical view of Solvency II; the report notes both the sheer extent of Solvency II regulation (the Directive text, the level 2 text and the EIOPA Guidelines run to over 3,200 pages), and the Directive's staggering implementation and continuing costs for the UK industry (£2.6 billion to implement and running at a further £196 million each year).

However, the Committee has stopped short of recommending that Solvency II be replaced after Brexit. The Committee recognized that Solvency II's implementation has been very costly, and although there are areas which are defective, it is thought possible to improve its implementation without abandoning it altogether. However, this would need a new approach from the regulator. The PRA needs to explain its thinking on the industry's suggestions for improvement, and it needs to consider its responses with more of a post-Brexit mentality. The Committee was concerned that the PRA's excessively strict interpretation of the requirements of Solvency II, and of its own obligations, has limited its thinking in a way which could be detrimental to UK plc.

The Committee noted that during the inquiry, the Association of British Insurers had provided a list of 23 areas where the PRA's implementation of Solvency II could be improved, but the PRA accepted just five of those 23 suggestions. The PRA should make substantive progress on those it does agree with and take a fresh look at the other 18 in the context of the greater freedom of regulation that Brexit might bring.

Detailed Recommendations

The Treasury Committee made a number of specific recommendations. These included that the PRA should:

- provide a solution for the risk margin to improve its calibration, preventing over sensitivity to low interest rates in the calculation of insurers' capital requirements
- develop proposals for the introduction of regulatory forbearance at the national level to deal with procyclicality – so insurers will not be required immediately to divest assets in a falling market, exacerbating an emerging economic crisis
- develop proposals for the matching adjustment and the volatility adjustment to accommodate more flexibility and a more principles-based approach, and reduce the requirement for insurers to develop complex structures to achieve the regulatory treatment that they warrant
- agree with the industry on an approach to the treatment of illiquid assets, balancing prudential concerns with the desire not to create unreasonable barriers to insurers investing in long term assets
- set out proposals which reduce the amount of data required from firms to a level that the PRA can clearly demonstrate is proportionate and necessary for prudential safety

- consider whether UK regulation post-Brexit can be better aligned with new international financial reporting standards, IFRS17
- develop proposals to remove limitations in the standard formula, and improve the sophistication and usefulness of internal models and
- develop a solution for firms who will lose the legal validity of their contracts after Brexit (when it may be impossible for insurers to pay claims if EEA passporting rights to carry out insurance contracts cross-border between the UK and Europe have been lost).

What Next …?

The general tone of the Report is one of support for the UK insurance industry, and skepticism about current regulatory approaches and attitudes. The PRA has been told to take a hard look at itself, with regard to its implementation of Solvency II and its interaction with, and regulation of, the UK insurance industry, to address the specifics of how Solvency II can be improved, and to consider how it should respond to Brexit. The Committee is clearly serious about pursuing changes and has directed the PRA to begin to take action immediately and to report back on its progress by March 31, 2018. The industry is very interested to see what the PRA does next.

Financial Conduct Authority's Wholesale Insurance Broker Market Study

On November 8, 2017, the FCA launched a competition market study into the wholesale insurance broker market, which forms part of the FCA's objective of ensuring transparency in the wholesale markets, in view of their impact on the broader economy.

The FCA's stated mission is to "ensure that wholesale markets demonstrate transparency, open access, integrity and competition on the merits." The London insurance market is large and complex with around $91 billion in annual gross written premiums. If competition in this market is not functioning as it should, this will have a negative impact on the broader economy. In simple terms, if businesses are not getting the most appropriate coverage, or if they pay for more risk services than they should, or overpay for those services, that will affect their profitability and so their ability to operate, innovate, and grow.

As part of its role as the regulator for the financial services industry, the FCA has the power to enforce UK competition law, including by conducting market studies, which look at how competition is working in a particular market and assess whether it could work more effectively.

The FCA has published a Terms of Reference document setting out its initial thinking and the specific topics it plans to investigate in 2018, including:

- Market power – whether any individual broker firms have significant market power and, if so, what effect does this have on competition
- Conflicts of Interest – conflicts of interest may arise if, for example, a broker chooses an insurer or product for a client on the basis of the remuneration the broker will receive, rather than what is in the client's best interests and
- Broker conduct – whether there is evidence of collusion or coordination between broker firms and whether any broker practices lead to a reduction in competition; for example, when risks are placed through facilities rather than in the open market, does this exclude certain types of insurers.

The market study will involve the FCA taking an in-depth look at how businesses and clients operate. The FCA is expected to undertake an extensive information gathering exercise, which will inform its assessment of the market. At the end of the market study, the FCA will produce a detailed final report which will set out its findings and intended course of action. The FCA has wide-ranging powers to impose any remedies it considers necessary to address any competition problems identified, and these can have a significant impact on the affected businesses.

Businesses which may be directly or indirectly affected by the FCA's market study into the wholesale insurance broker market have the opportunity to provide input and so influence both the scope of the market study and the FCA's emerging thinking. The FCA's Terms of Reference were open for comments until January 19, 2018, and the FCA listed a number of questions on which views were invited. The FCA will also send market players questionnaires as part of its information gathering exercise.

We will expect its findings later in 2018, together with any consequential legislative or regulatory changes. Given that the FCA's powers are wide-ranging, it is possible that its review could have a significant impact on the wholesale insurance broker market. A previous competition market study into payment protection insurance (separate to the mis-selling investigation) resulted in a ban on the sale of payment protection insurance at the point of sale of the underlying credit product. This had a major impact on many financial services businesses and some ceased to be viable as a result. A further possible outcome is that if the FCA uncovers any conduct it suspects is an unlawful breach of competition law, for example, if it finds evidence of collusion, it may bring enforcement action against the businesses concerned which would mean an investigation and possible fine.

France

Increased Powers for the High Council for Financial Stability (HCSF)

This year has seen the implementation of Law No. 2016 of December 9, 2016 on transparency, anti-corruption and modernization of the economy, which is referred to as the "Sapin 2 Law." The Sapin 2 Law introduced several important new measures regarding life insurance, which include the strengthening of the powers of the macro-prudential authority to exercise oversight of the financial system as a whole, namely the new HCSF.

The HCSF is a continuation of the Financial Regulatory and Systemic Risk Council, which aims to put in place more rigorous macro-prudential supervision, which was established in the wake of the financial crisis. The Sapin 2 Law has given the HCSF more extensive binding insurance powers, particularly with regard to life insurance policies. Such measures can include temporarily prohibiting certain operations or activities, including disposal of assets or limiting the payment of cash surrender values.

Poland

Activity of the Polish Financial Supervision Authority in 2017

Financial Supervision Authority Reports and Recommendations

Throughout 2017, the Polish Financial Supervision Authority (KNF) has published a number of reports on the insurance market. Two reports of note are set out below:

- Information on mandatory civil liability insurance for vehicle owners, the amount of indemnity and the value of insurance premiums. This report considered (i) the influence of changes in insurance law, and (ii) the rulings of the Polish Supreme Court on insurance companies' scope of liability and the quantum of insurance premiums. The KNF also reported on the fact that there is a visible correlation between the Supreme Court's rulings on the topic of due compensations, and the average value of insurance premiums and their latest increase. The report also considered the average amount of compensation given for the death of a relative in a communication accident, and the Supreme Court's rulings on the same.
- Information relating to the work of the Compensation Forum. This report looked at the possibility of increasing the stability and reliability of compensation by creating legislative proceedings to calculate the amount of compensation to be paid out, *eg*, based on fixed compensation tables. The Compensation Forum conducted research on compensation sums paid out during the last year and found that the compensation due can be precisely calculated based on big data research.

The KNF has noted that the rapid growth of the FinTech sector is a challenge for the market supervisory entities and that challenge should be addressed. The KNF has decided that the growth of innovative finance technologies should be supported by supervisory entities, and to do so, the practice of "gold-plating" should be eliminated.

Financial Ombudsman

The Polish Financial Ombudsman issued two important reports for the Polish insurance market in 2017:

- Financial Ombudsman's report on school insurance.
- Supervisory guidelines in a scope of loss adjustments in communication damages and the practice of insurance companies in that subject.

Ownership Changes in the Polish Insurance Market

On May 4, 2017, Poland's largest insurance company and one of the largest financial institutions in Poland, PZU Group, together with the Polish Development Fund, PFR, received the KNF's permission to acquire a 32.8 percent shareholding in Pekao Bank for a total value of €2,517 billion. As a result of the transaction, PZU Group is now the largest financial group in Eastern Europe.

Italy

Public Consultation 3/2017 on the Simplification of Non-Life Pre-Contractual Information

On August 30, 2017, IVASS, the Italian insurance regulator, published Consultation Document 3/2017 on the disclosure duties for proposers of insurance policies and the advertising of insurance products.

The consultation document's publication followed the approval of EU Regulation 2017/1469 and set out a standardized presentation format for insurance product information documents (IPIDs).

An IPID must include the following content:

- The risks covered by the policy
- Who and what is not covered by the policy
- Coverage limits
- Territorial scope of the policy
- The insured's obligations
- How and when will the premium be paid
- The policy's duration
- How withdrawal from the policy can be exercised

No amendments to the standard format set out above are allowed, but under the new proposal, undertakings can submit to proposers a supplemental IPID containing additional information on the insurer and the policy, including: (i) the undertaking's financial data; (ii) the policy limits; (iii) the consequences of non-disclosure; and (iv) how a claim should be made.

The information in the supplemental IPID must be consistent with that contained in the standard document, and neither the IPID nor the supplemental IPID can refer to policy clauses. Further, reference to legal provisions cannot go beyond what is strictly necessary.

No exemptions are provided other than with regard to large risks, for which an IPID is not required.

Pre-contractual documents should be submitted via email or through the insurer's website, subject to the proposer's prior consent. The insurer must also (i) send the potential policyholder a link via email to the webpage where the documents can be found, and (ii) ensure that the documents are accessible for the period in which they may be used by the policyholder and until the expiry of the two-year limitation period referred to in Article 2952 of the Italian Civil Code.

The deadline for submitting observations and comments on the amending proposals to IVASS passed on October 5, 2017, and submissions are currently being reviewed.

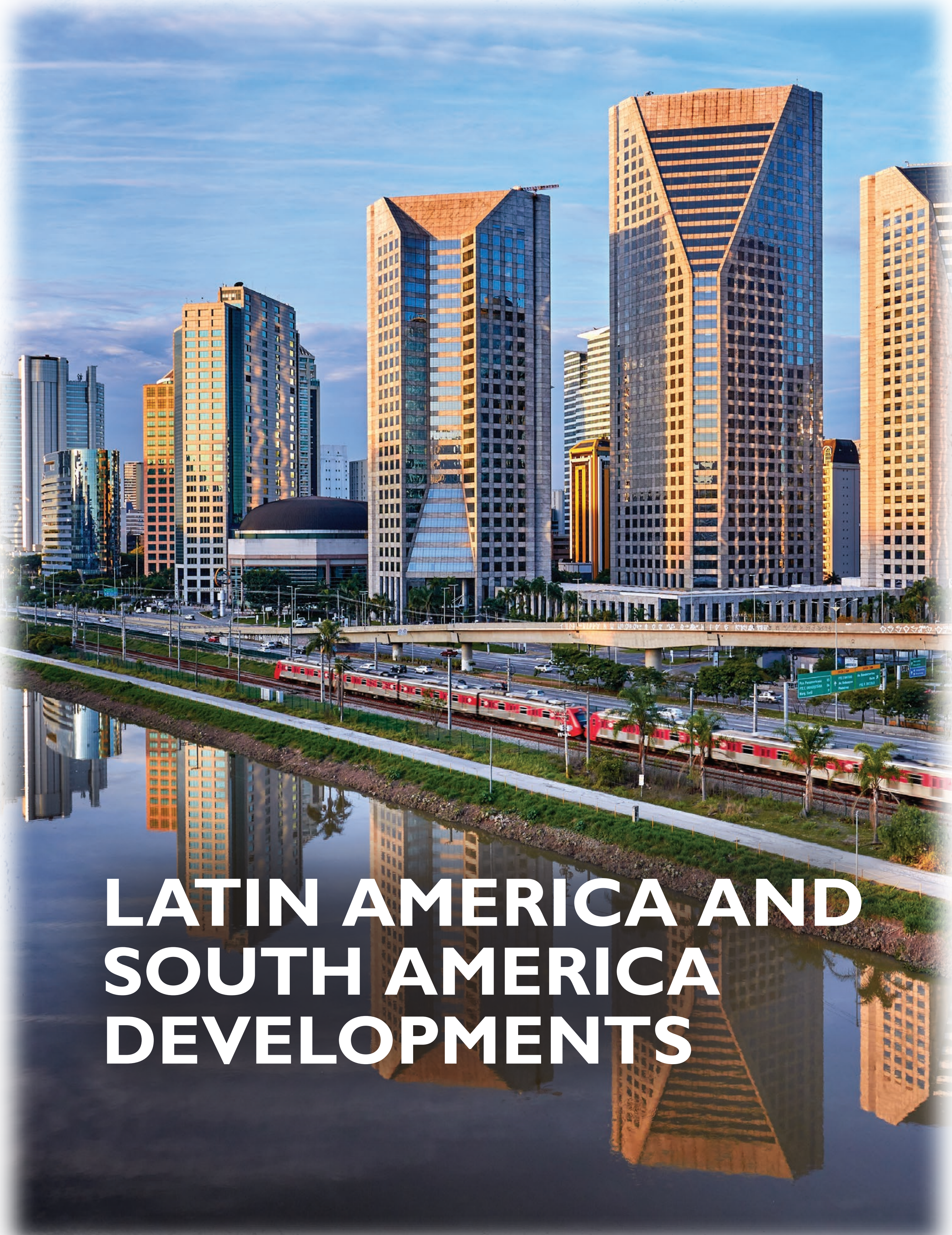
Belgium

Regulatory Changes

The Belgian insurance sector has adapted to various regulatory changes in 2017. The national legislator, urged by the sector's prudential supervisor, the Financial Services and Markets Authority (FSMA), undertook legislative initiatives to introduce a new regulatory framework, which is increasingly focused toward policyholder protection.

The Belgian Act of July 30, 2013 on the empowering of the protection of buyers of financial products and services and on the scope of authority of the FSMA increased information transparency and protection of the buyers of insurance products. It expanded the scope of the MiFID rules to the insurance sector. The Act imposed similar "know your customer" obligations on insurance companies as the ones already existing for banking institutions. The FSMA issued two separate sets of guidelines providing for more elaborate information requirements for the insurance sector. The new legislation is expected to be coupled with increased market scrutiny over insurers in Belgium.

This increased consumer protection is also evidenced by the obligation under IDD to offer non-professional clients with a brief summary of the main features of a non-life product in a one-page document.



LATIN AMERICA AND SOUTH AMERICA DEVELOPMENTS

Brazil

Regulatory and Legislative Developments

2017 marks 10 years of the opening of the reinsurance market in Brazil. It was also the year that the IRB (the former Brazilian reinsurance monopoly) made an initial public offering in the Brazilian stock exchange.

This year was also marked by SUSEP (the Brazilian insurance regulator) being closer to the market, looking to understand areas where regulation can be developed, and creating closer links with foreign regulators to further understand supervision. SUSEP is focused on the following:

- **Mandatory placement.** We understand that the regulator is eager to review the need for the co-existence of regulation for the mandatory placement of 30 percent of the business with local reinsurers and the rule relating to the mandatory offer of 40 percent of the business to the local market.
- **Intra-group placement.** There is also questioning of the need to restrict intra-group cession of risks (currently limited to 30 percent), which on one hand ensures business is placed with more market players and that the risk is spread across the market, but on the other hand has caused a resistance for international market players to propose new products to the local market, and increases in the cost of reinsurance and counterparty credit risk.
- **Solvency II.** SUSEP is expected to fully regulate Own Risk and Solvency Assessment by 2019. This will likely represent a transformation of how insurance companies operate in the country, including a requirement for forward-looking solvency assessments and business decisions tailored to risk-taking choices. Currently, insurers are already required to have a director responsible for risk management and are required to implement risk management structures by December 31, 2017.
- **Insurance contract bill of law.** As there are no specific laws regulating insurance contracts in Brazil other than the Civil Code, a bill of law for insurance contracts was proposed to consolidate and regulate the main provisions in a single legislation. The bill intends to bring together in a single law all the provisions related to insurance, such as life and non-life insurance, mandatory insurance, reinsurance, claims adjustments, among other matters. In December 2016, the bill was unanimously approved by a special commission in Congress, and was then submitted to the Senate. It is expected to be approved by the Senate in 2018.

Mergers and Acquisitions

Insurers[1] and intermediaries[2] continue to invest in acquisitions as a way of consolidation. Insurers are looking to broaden their client base, by entering into distribution arrangements with large retailers in the country[3] or by acquisition of existing portfolios from other players, including insurers owned by banks divesting of large risks. The most significant acquisition of portfolios was the ACE (now Chubb) acquisition of Itau's large insurance portfolio and Bradesco's joint venture with Swiss Re.

Chile

The insurance market in Chile is competitive and throughout the years has been attractive for foreign investments. According to recent studies, as of December 2016, 42 insurance groups were operating in Chile, including 29 general insurance companies and 40 life insurance companies. New companies have focused mainly on acquiring local insurance companies with similar core business or incorporating local companies.

Additionally, the premium growth in medium and long term is steady. In fact, premium growth has tripled in the last 10 years..

Regulatory and Legislative Developments

In 2017, there were two noteworthy pieces of legislation:

- Law N° 21.000 that created the Commission on Finance Market (2/23/2017), which will replace the Superintendence of Securities and Insurance in August 2018 or, as the law details, when the Commission starts functioning, which ever occurs first will maintain all the functions that the Superintendence currently has, but pursuant to this reform, structure will change from a single Superintendent to a Commission of five members. Additionally, it improves the administrative procedure, by separating enforcement functions, which will be performed by the Commission prosecutor; and the Commission itself will be in charge of sanctions.
- Law N° 20.920 (6/1/2017): Article 7 mandates the administrators of hazardous waste take out liability insurance for third parties and the environment.

Future and Current Challenges

There are two main challenges that can be highlighted. On one hand, according to some, waste insurance may be hardly applicable since the law mentioned is not clear when explaining the limits of strict liability. In other words, insurance companies can be reluctant

1 In 2015, AXA acquired SulAmérica, a large risks business for €40 million. The acquisition fueled AXA's expansion in the Brazilian market and increase its growth prospects.

2 In 2016, AON announced a deal to acquire Admix in order to build its position in the growing private health insurance market.

3 Early 2017, Zurich entered into an agreement with Via Varejo, the largest retailer in the country, to expand the lines of distribution and a separate agreement with Fast Shop, a premium retailer, for distribution of insurance. AXA also secured the distribution channel with Pernambucanas earlier this year.

to assume this risk and, therefore, we will have to pay attention to the solutions that may arise. On the other hand, ARIAS Latam took the first arbitration case since its creation concerning the overflowing of Mapocho River. The involved companies were Sacry, HDI Insurance and Mapfre Insurance (through coinsurance); and the risks were assumed in reinsurance by Generali Group and Mapfre Re. This is a significant piece of news that may change insurance case law in Chile.

Colombia

Significant institutional activity occurred in the insurance industry in 2017. Several regulatory and legal decisions were made, which focused largely on the protection of consumers and safeguarding the interests of policyholders and insureds. The Colombia Superintendence of Finance's intervention in the insurance market was particularly controversial as the Superintendence took certain positions increasing the cover of insurance policies and allowing insureds access to indemnifications when resolving jurisdictional disputes. Given such actions, the Supreme Court of Justice took similar positions and issued court orders that expanded the authority of judges, which historically interpreted policies on a restricted and limited basis. These Supreme Court orders have created general uncertainty in the sector.

Regulatory and Legislative Developments

Aside from the institutional context, 2017 was remarkable due to:

Bancassurance

Despite decisively promoting commercialization of insurance through banks since 2012, in 2017 the Superintendence largely restricted such commercialization, through limiting the structures through which insurance can be offered to the general population.

From a relatively open structure, financial entities now must choose between two very limited alternatives to commercialize insurance: either taking them on behalf of their clients (in which a series of very demanding selective procedures are needed), or lending their office network to an insurance company for commercialization (in which the financial entity's participation in the process would be very limited).

Intermediary Liability

The increment of actions against insurance intermediaries should also be noticed. Throughout 2017, Colombia became a very receptive jurisdiction to the liability action against insurance brokers, agents and agencies.

Several lawsuits have been filed; each time with more chances of success, for errors and omissions of the intermediaries in the subscription process, the proposal form, the emission of the policy and in the formulation of reclamation and procedures for accidents, with a probability of being condemned, which was unusual in Colombia.

Mexico

The penetration of insurance is still low in Mexico, albeit it is an important reinsurance market due to the catastrophe risk the country is exposed to. Although most people are still not insured in Mexico, the insurance market in Mexico is growing.

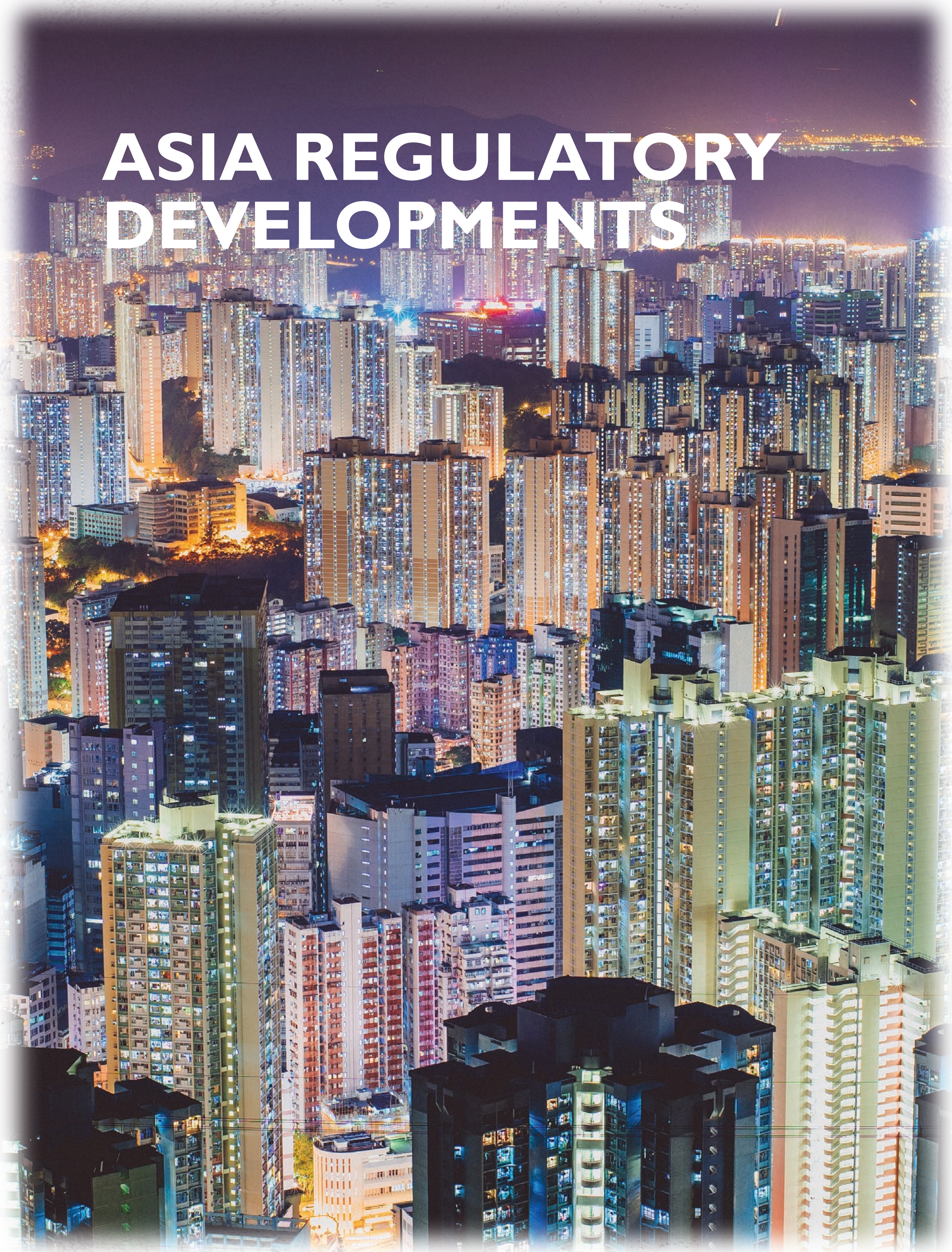
In the first quarter of 2017, the insurance industry grew in real terms by 2.1 percent in comparison to the same period of 2016. As of the third quarter of the year, the CNSF reported 84 million life insurance, 12.8 million medical expenses, and 6.8 million civil liability insurance policies nationwide. There is a huge market potential in Mexico, considering the amount of insurance policies existing in place and a population of 127 million and that Mexico is placed second (just after Brazil) in the insurance market for Latin America.

As a result of the recent earthquakes in Mexico City (September 7 and 19, 2017); 38,291 claims were filed before the different insurance companies representing MXN$16 billion Mexican pesos (approximately US$838.7 million dollars) to be paid in claims. The natural catastrophes have increased the awareness of the population to the importance of having insurance coverage, especially for property-casualty insurance and life insurance.

Regulatory and Legislative Developments

In the aftermath of the earthquakes, the Mexican Insurance Institutions Association is considering proposing for 2018 the following regulation: (i) mandatory damage insurance for all buildings that are constituted under a condominium regime and (ii) from the funds received for housing reconstruction by the Federal Government Disaster Fund, allocating certain amount to a mandatory catastrophe insurance.

ASIA REGULATORY DEVELOPMENTS



Hong Kong

The Insurance Companies (Amendment) Ordinance 2015 – Update

In our 2016 *Year End Review*, we referred to the key legislative amendments of the Insurance Companies (Amendment) Ordinance on the understanding that such would be fully effective in mid-2017.

As earlier pointed out in the 2016 report, this comprehensive overhaul of the Hong Kong regulatory regime includes the establishment of an Independent Insurance Authority (IIA) and bringing the regulation of agents and brokers (currently self-regulated) within the jurisdiction of the new IIA.

While the commencement date of this Ordinance was unfortunately delayed (as it was originally expected to be fully effective in the year 2016), many (but still not all) of the provisions have now come into effect as of June 26, 2017, being the date on which the IIA was officially established.

While this step has been encouraging, the work of the IIA is still slow, resulting in a backlog of insurance license applications, other related regulatory issues and domestications – see below for more detail on this. Furthermore, the introduction of regulation of agents and brokers continues to be delayed and it is now expected that the earliest date for such regulation to be effective is mid-2019.

As earlier pointed out in the 2016 report, such reform has been seen as an important step toward recognition of Hong Kong as sitting in the top league of global financial centers, properly, efficiently and competently regulated to a high level of integrity and to international standards. The IIA is showing its commitment to bringing the Hong Kong insurance industry in line with its international competitors and bring the Hong Kong regulatory and compliance framework to a level which recognizes the IAIS. Among recent developments:

- There are proposals as of September 2015 to introduce a risk-based capital framework in line with the IAIS ICPs.
- There are proposals to introduce group supervision. The has expressed an interest in being part of a transitional regime for third country equivalence under Solvency II, which requires group supervision.

The Immediate Future – a Positive Outlook

While it is early days under the new regime, market perception is that the IIA is determined to adopt a far more commercial and pragmatic approach to carrying out its functions and responsibilities and fulfilling its vision of developing the insurance industry in Hong Kong. Historically, the Office of the Commissioner of Insurance (OCI) took a hands off-approach to its regulation of the insurance industry, often attracting adverse comment that it was not being sufficiently proactive in enhancing the industry's growth and development and leaving such to market forces. We are now seeing new initiatives for change with market consultation being at the forefront of such initiatives.

The Hong Kong government has also publicly announced its intention to return Hong Kong to a marine hub with insurance playing a major role in the augmentation of such vision. As a result, P&I clubs are continuing to establish their physical presence in the territory and seeking licenses to write business from Hong Kong and we anticipate a considerable increase in premium from the placement of marine insurance cover out of Hong Kong over the coming years. This is particularly so due to the growing appetite of marine insurers to enter the Chinese market which, to date, has been largely left to Chinese insurers for a variety of reasons.

The recent changes, while long overdue, are encouraging and the future of Hong Kong's insurance industry bodes well as such positive changes in both legislation and regulatory culture are anticipated to provide the environment for significant and robust long-term growth.

The Rise of Domestications and a Road Map to Success

As mentioned above, the work of the IIA is still slow. This is partly a result of the transition from Hong Kong's former insurance commission, the OCI, to the IIA but it is also a result of the increasing number of insurance license applications and other related regulatory issues, including "domestications" via a transfer scheme under Section 24 of the Insurance Ordinance 2015 (Section 24 Scheme) to a Hong Kong incorporated and licensed subsidiary.

Commercial Drivers

There are a number of common commercial drivers for Section 24 Schemes including:

- improved efficiencies of scale/ better financial stability due to diversification benefits
- better aligning the insurer group's operating units along regional lines
- improving longer term corporate flexibility
- more efficient conduct of administrative responsibilities
- simplified administration of the portfolio/ increased efficiency of capital management
- increased efficiency of audit and regulatory compliance and

- removing the tensions that currently exist within the transferor as a result of the differing risk profiles and regulatory regimes that apply to its Hong Kong and non-Hong Kong businesses, leaving each territory to pursue the strategy that best fits the needs of its market, policyholders and shareholders.

However, more recently, the regulatory costs and burden of Solvency II, and much more recently, the Bermuda Solvency II equivalence implementation, have incentivized Hong Kong insurers operating as Hong Kong branches of European or Bermuda incorporated and licensed insurers to consider "domesticating" via a Section 24 Scheme to a Hong Kong incorporated and licensed subsidiary. Our understanding from speaking with our other insurance sector clients and professional advisers in Hong Kong is that the IIA currently has more applications for Section 24 Schemes than ever before.

Key Legal Principles

The Insurance Ordinance 2015 confers an absolute discretion on the Hong Kong Court whether or not to sanction a Section 24 Scheme. However, the Court's discretion must be exercised by giving due recognition to the commercial judgment of the insurer's board of directors. As long as the directors of each relevant insurer are acting in good faith and in the best interests of the insurer, the Court will not "second guess" the directors' judgment. The commercial drivers/rationale for the Section 24 Scheme will need to be carefully explained to the Court and will need to be supported by the conclusions and recommendations in the independent actuary's report.

Timing and Process

As a result of the IIA's current workload, we expect a start to finish timeline for a Section 24 Scheme of between 18 and 24 months.

Phase 1 is the preparatory stage including preliminary meetings with the IIA. Phase 2 involves submission of draft Court and scheme documents and the independent actuary's report to the IIA, the IIA's clearance of such drafts and submission of the finalized documents and report to the Court. Finally, Phase 3 involves handling all policyholder enquiries and complaints, the Court filings and Court hearings.

China

Restrictions on Foreign Insurers Operating or Expanding in China

There is a strong need for a relaxation of the conditions imposed on the opening of branches by foreign-invested insurers. Presently, if a foreign investor owns more than 25 percent of an insurer in China, the insurer is classified as a foreign-invested insurer and any branches opened by such an insurer are subject to much greater restrictions and scrutiny, for example:

- The China Insurance Regulation Commission (CIRC) imposes, as a matter of institutional policy, strict geographical restrictions on the opening of new branches by foreign insurers. Foreign insurers are allowed to open one or two branch licenses a year while domestic players have no limit and get several licenses in one go. Furthermore, the procedure applied to foreign insurers lacks transparency and usually involves a long completion time;
- Converting (incorporating) foreign property and casualty insurance branches into subsidiaries is an essential requirement for further expansion into more provinces because only subsidiaries can establish branches. This has been legally possible for four years but, in practice, the procedures turn out to be highly selective, lacking in transparency, and often take a long time; and

- Foreign insurers are not permitted to invest in more than one property and casualty insurance and life company in China (as per a rule introduced in 2008 by the CIRC). The objective of this regulation is to prevent foreign insurers from getting overly involved in Chinese companies.

Domestication of Foreign Insurers – Getting a Smaller Piece of a Bigger Pie

There has been a fairly recent trend of some foreign-invested insurers becoming domestic insurers by giving up their majority control and taking a smaller cut of an expanded stake, for example:

- In 2012, AXA Life moved from a 50:50 joint venture with Minmetals to become the ICBC-AXA Life Insurance (60 percent ICBC to 27.5 percent AXA to 12.5 percent Minmetals) joint venture, which transformed a business that only had 16 branches as of September 2011, to a business with access to ICBC's more than 16,000 branches across China.
- In 2010, Sun Life Financial diluted its ownership from 50 percent to 25 percent in Sun Life Everbright Insurance, its joint venture with China Everbright Group, thus enabling the joint venture to gain legal status as a domestic insurer. This led to the joint venture being allowed to offer a wider range of products and open more branches across China at a faster pace.

Bucking Regulatory Restrictions through an Online Approach

Online sales platforms (coupled with China being the global leader in e-payment services technologies and penetration) could eventually help foreign invested insurers overcome the key disadvantage of being allowed to establish no more than two branches a year. Since 2011, the CIRC has been encouraging insurers to grow their businesses through e-commerce. In particular, on July 22, 2015, the CIRC issued the "Notice on Issuing the Interim Measures for the Supervision of the Internet Insurance Business," which specifies the basic requirements of participating in internet insurance businesses, such as relevant qualifications; operation criteria; geographic scope; information disclosure; and the CIRC supervisory rules.

The relevant product requirements are in fact the same as those governing the offline insurance business.

Pursuant to this new regulation, certain insurance products can now be sold online, without geographical limits, even though no branch/subsidiary of the insurer has been established. Those permissible online products include:

- personal accident insurance, fixed-term life insurance and ordinary whole life insurance
- household property insurance, liability insurance, credit insurance and guarantee insurance with an individual as the policyholder or the insured and
- property insurance and the whole transactional process, including sales, underwriting and settlement of claims can now be operated online

The arms race among the big three internet companies in China has accelerated the development and sophistication of online sales platforms for insurance products in China. For example:

- In 2014, Alibaba and Tencent joined forces with Ping An Insurance, the second largest insurer in China, to set up Zhong An Online Property Insurance; and
- In 2015, Baidu partnered with global insurer Allianz and Asian investor, Hillhouse Capital Group, to establish a digital insurance joint venture called Bai An.

Non-Life Business: The Chinese Motor Industry and its Pitfalls

Foreign non-life companies are excluded from offering motor third party liability insurance (Motor TPL). As Motor TPL amounts to more than 70 percent of the entire non-life business, this is a severe disadvantage.

Motor TPL is loss making due to the high accident rates, poor underwriting, inflated/fraudulent claims and low third party liability limits (only US$52 premium income per car in 2011). According to Fitch, the price liberalization of Motor TPL premiums (rolled out by the CIRC in June 2015 in six Chinese regions initially, then in 12 more provinces and cities from January 2016 onwards) has encouraged smaller insurers to try to win market share by discounting, leading to an increase in competition and greater price sensitivity among consumers. In turn, the bigger insurers have followed suit. This, coupled with an influx of new players, could further constrain major insurers' capability to improve their margins. Average motor premiums have fallen by 5.3 percent since the reforms started, according to CIRC.

This opening up of the Motor TPL to foreign invested insurers has been long promised, for instance, the May 2011 pledge at the US-China Strategic and Economic Dialogue meeting to open up mandatory car insurance to foreign invested insurers.

In the meantime, certain foreign invested insurers are partnering up with domestic insurers since foreign invested insurers are able to offer optional car insurance – *eg*, Samsung Fire & Marine's cooperation agreement with Huatai Insurance whereby Huatai will sell MTPL policies while Samsung Fire & Marine will sell optional "top up" cover to the same policy holders.

Indonesia

In 2013, the Indonesian regulator (OJK) was established and tasked with supervising non-banking-related financial sectors (including insurance). As a new agency, it naturally faces some elements of coordination, overlap and delay, both internal to the organization and across government agencies. Since the OJK's formation, the insurance industry has experienced significant regulatory change which is on-going. The New Insurance Law (UU No. 40/2014) came into effect on October 23, 2014 (New Insurance Law).

Product Approvals

The process of obtaining approval from the OJK is extremely lengthy as all new products need to be approved. One of the reasons for this is that the OJK is internally separated into banking and insurance units. Often, to launch more sophisticated products in the insurance sector, approval is needed from both the banking and insurance units. The internal teams do not appear to be coordinated so this delays the process and increasing reliance on internal networks to speed things along.

Digital and Liberalization of Distribution

Even though the Indonesian insurance market is developing toward more modern methods, the market preference remains a traditional distribution method. Almost all new product sales require some form of intermediation from a regulatory perspective, either face-to-face or by telephone.

There is little e-commerce in Indonesia despite huge smartphone usage and huge social media adoption (Facebook, Twitter, and WhatsApp). However, buying online is almost non-existent. This may be due to Indonesia's lack of reliable infrastructure (roads, courier services) for the shipment of goods and peoples' low levels of trust in many institutions and businesses.

Digital has a role in creating more efficient sales processes. Currently, few life insurers use digitally-enabled sales processes. However, e-commerce is growing at a tremendous pace and the market is slowly coming to welcome it in Indonesia.

In December 2016, the OJK approved an IT-based money lending service in Indonesia. Despite this, the OJK has stayed cautious and wary when approving transactions and processes of this nature when concerning e-commerce sales.

Governance

There is a significant governance burden: insurers are required to hold monthly board of commissioners (BOC) and board of directors meetings. The BOC would be akin to a UK board of directors, with non-executive and executive directors represented. There is also a requirement for monthly risk and audit committees and these have to have majority independent representation. Eighty percent of the meetings have to be face-to-face. This is a significant resource commitment. Due to the requirement to have the meetings on a monthly basis, there is often little to discuss at a strategic level as things rarely change that quickly.

Change in Ownership Requirements

Under the New Insurance Law, insurance and reinsurance companies can only be owned by either:

- Indonesian individuals and/or Indonesian legal entities that are directly or indirectly wholly owned by Indonesian individuals or
- Indonesian individuals and/or Indonesian legal entities together with foreign individuals or legal entities that are engaged in the same insurance business or a holding company with one subsidiary engaged in the same insurance business.

Foreign individuals referred to in the second bullet point above can only hold shares in an insurance or reinsurance company through a transaction on the stock exchange.

Existing companies that do not comply with these requirements must adjust their shareholding by November 2019 at the latest by:

- transferring their shares to Indonesian citizens or
- going public.

Companies must prepare an action plan to comply with the ownership requirements, along with the steps they will take to achieve compliance and a timeline for implementation. This action plan must be completed by June 2017.

The government is also required to issue a government regulation regarding foreign ownership in insurance companies, which has yet to be issued. Pending the enactment of this government regulation, the maximum foreign ownership in insurance companies is subject to the provision under the old insurance law of 80 percent. It is expected that the new foreign ownership requirements will be more stringent.

These restrictions are expected to equally apply to insurance/reinsurance intermediaries and other providers of insurance/reinsurance-related services.

Single Presence Policy

The New Insurance Law also introduced a "single presence" policy to the insurance sector in Indonesia. This law provides that each party can only be the "controlling shareholder" of one of each of the following categories of insurance companies:

- Life insurance company
- General insurance company
- Re-insurance company
- *Syariah* life insurance company
- *Syariah* general insurance company
- *Syariah* re-insurance company

Insurance companies were expected to comply with the single presence policy before October 17, 2017 through the adoption of an implementation plan, which is to contain the information on the adjustment method, the step plan and the timeline.

The implementation plan must be approved by an insurer's shareholders. Further, it was to be submitted to the OJK by or before June 28, 2017.

The OJK would then approve the implementation plan or ask for revisions within 20 working days of receipt.

Insurers must submit a report on the realization of the approved plan within 10 working days after the realization of the plan or after the realization of any stage set out in the plan.

To comply with the single presence policy, a controlling shareholder can merge or consolidate the insurers under its control, or partially sell its shares in the insurers under its control or do other corporate actions based on the OJK's approval. This policy has resulted in an active market this year and beyond for M&A.

Singapore

Banks' Long-term Deals with a Single Insurer

Presently in Singapore, big banks have secured long term deals with a sole insurer. This has been mainly driven by the desire/need to secure high upfront guaranteed payments and on-going performance related payments.

An open architecture environment in Singapore would help increase insurance penetration and growth, encourage healthy competition and consumer choice. It would:

- provide greater customer choice of both products and distribution channels. This would help to narrow the protection gap which currently stands at US$609 billion in Singapore
- limit current practice of bundling together the policies which are "available" rather than what the customer may need to meet their needs
- support the Financial Advisory Industry Review (FAIR) requirement of Quality Advice as a bank is able to offer experienced, trained staff with a good compliance infrastructure
- remove exclusive market deals, which are expensive as a result of the high upfront guaranteed and on-going performance related payments. These payments, which are linked to exclusivity, make Bancassurance the most expensive distribution channel and the cost is ultimately borne by the customer and
- align more closely to the FAIR requirement of Spreading of Commission as the current arrangement of upfront payments is in effect, front loading commissions, which is contradictory to what the Singapore regulator is seeking to do in terms of fair practices for customers. This would also support better customer management by the banks as commissions are spread over the term of the policy encouraging an ongoing relationship.

Simplification of Digital Processes

Existing legislation limits insurers' future direct/digital capability. There are simplifications that may be made to online verification processes (*ie*, to simplify the journey for customers). For example,

- a "fact find" is required for all financial purchases (except Term and GI and the government-linked health and long-term care schemes). This limits insurers' ability to serve the customer in a direct way. A better approach would be that the customer should be able to choose whether they want to complete a full fact find or skip the process if they want to;
- the anti-money laundering and KYC guidelines state that customer identification and verification has to take place before a policy can be issued. Facilitating this online (real time) or offline through manual checks and processes leads to additional costs. Insurers have implemented this through camera technology but there are still parts of the legislation that put obstacles to the digital customers' journeys; for instance, the requirement to have a signature for all policy servicing requests. A possible solution to identify verification/policy servicing changes/wet signature requirements could be the use of the national "one key" token which is being issued to all Singaporeans or indeed, through email verification, which has already been widely accepted in Hong Kong.

Vietnam

Foreign Ownership Restrictions and Requirements

From a legal perspective, there is no foreign ownership restriction applicable to foreign insurers for entry into Vietnam. Notwithstanding this, there are certain specific provisions applicable to foreign insurers that insurers are hoping to be relaxed, as follows:

- permission for foreign life insurance enterprises to establish branches in Vietnam
- permission for foreign reinsurance enterprises to establish branches in Vietnam (noting that a similar provision is included under the Free Trade Agreement that has been negotiated between the EU and Vietnam (EVFTA))
- removal of restrictions on the cross-border provision of insurance retrocession services (noting that a similar provision is included under the EVFTA) and
- there are certain specific conditions applicable to foreign insurers to be able to establish their subsidiary in Vietnam in the form of limited liability companies. In particular, foreign insurers must:
  - trade in insurance abroad and have been permitted by the relevant foreign authorities to conduct expected business lines in Vietnam, or act as an outward investing subsidiary of a foreign insurance enterprise and have been mandated by the foreign insurance enterprise to invest in the incorporation of an insurance enterprise in Vietnam
  - have operated for at least 10 years in the sector of business in which they intend to engage in Vietnam
  - have total assets worth at least US$2 billion in the year immediately preceding the year that the application for licensing is submitted and
  - have not seriously violated any laws on insurance business and other legal regulations of their home country for three consecutive years immediately preceding the year that the application for licensing is submitted.

Additional Restrictions

There are certain additional points that should be considered.

- A stronger framework for the protection of trademarks and IP rights under a free trade agreement. For example, the EVFTA contains several provisions aimed at improving the legal framework for the enforcement of IP rights in Vietnam
- Mutual recognition of professional qualifications and
- The provision of strong and efficient investment dispute resolution mechanisms that could enable foreign insurers to protect their rights and guarantee the application of investment protection provisions applicable to them.

AUSTRALIA AND NEW ZEALAND DEVELOPMENTS

Australia

2017 saw the continued focus of the corporate regulator, the Australian Securities and Investments Commission (ASIC) into the sale of add-on insurance products and life insurance products to retail customers. ASIC has proposed a number of reforms in these areas. The insurance sector will continue to face scrutiny in 2018, following the announcement of a Royal Commission inquiry into the financial services industry.

Sale of Add-on Insurance

In 2017, ASIC continued to focus on reforming the sale of add-on insurance through car dealerships, following their 2016 Report 492.

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

Throughout 2017, ASIC has worked with insurers who sell, or have sold, add-on insurance through car dealerships to see that improvements are made to the sale and design of add-on products, and will continue to do so in 2018. Some insurers have already implemented significant refund programs as a consequence of ASIC's review.

In August 2017, ASIC announced proposals to reform the sale of add-on insurance through car dealerships. Consultation Paper 294 sets out ASIC's approach and proposed reforms in detail.

At this stage, the reforms have not been implemented. If they proceed, the reforms would see the introduction in 2018 of:

A Deferred Sales Model

This model would insert a pause in the sales process for add-on insurance products. The proposal is that a period of between four to 30 days must elapse before dealers could sell an add-on insurance product to a customer.

Enhanced Supervision Obligations on Insurers

This reform would see the introduction of more robust and targeted requirements for insurers to meet when supervising and monitoring their authorized representatives who sell add-on insurance products.

These requirements would be based on the risks for customers. ASIC has indicated that appropriate risk indicators could include tailoring the level of supervision according to:

- the amount and basis on which commissions are earned and
- whether a representative has been identified as having a history of non-compliant or unfair sales practices.

Consumer Credit Insurance Sales Process

In August, ASIC announced the establishment of a Consumer Credit Insurance (CCI) Working Group, which has been tasked with improving outcomes for CCI customers. CCI has historically been a key focus for ASIC, with ASIC's view being that CCI is associated with poor consumer outcomes.

The CCI Working Group will progress a range of reforms. A key reform will be the introduction of a deferred-sales model for CCI sold with credit cards over the phone and in branches. If implemented banks will be prohibited from selling a CCI policy until at least four days after the customer has applied for their credit card.

The intention of this reform is to reduce the risk that the customers will feel pressured to purchase the CCI policy or purchase a CCI policy that does not meet their needs. The deferred-sales model will not apply to CCI sold online or with homes loans and personal loans (though other measures will be introduced to ensure good consumer outcomes in these areas).

The CCI Working Group will be responsible for determining how the deferred-sales model will work and, in addition, will determine:

- what measures need to be implemented for CCI sold with credit cards over the internet
- other measures to promote good consumer outcomes (including well informed decision making) for CCI sold with credit cards and other loan products and
- the data necessary to ensure that the success of these reforms can be monitored.

Life Insurance Conflicted Remuneration Reforms

The Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017 went into effect on January 1, 2018. The Act will have a significant impact on life insurance distributors and represents the government's response to a number of recent investigations into the life insurance industry. The Act amends the Corporations Act to remove the exemption against the ban on conflicted remuneration for benefits paid in relation to certain life insurance products. Conflicted remuneration is a benefit which could reasonably be expected to influence the choice of financial product recommended, or the financial product advice given, to retail clients.

As of January 1, 2018, the exemption to the ban on conflicted remuneration only applies to life risk insurance products, if:

- the benefit is a level commission or
- the benefit satisfies the benefit ratio requirements and claw-back requirements under the Act.

ASIC has the power to determine the benefit ratio requirements. The benefit ratio is calculated with reference to the benefit and the policy cost for the product (which includes premiums and other fees payable). The claw-back requirements require financial services licensees to pay back all or part of the benefit if:

- the product is cancelled or not renewed; or
- the policy cost is reduced, within two years after it is first issued to a retail client, and that benefit is equal to or greater than the amount set by ASIC.

The Act (and the associated regulations) also extends the ban on conflicted remuneration to situations where no financial advice is given. From January 1, 2018, it will be conflicted remuneration if the benefit relates to:

- information given to a person in relation to a life risk insurance product; or
- a dealing in a life risk insurance product with a person as a retail client,

and access to, or value of, the benefit is dependent on the value or number of the life risk insurance product(s) subsequently acquired or varied.

These changes are significant for the life insurance industry, as they extend the application of conflicted remuneration to non-advice scenarios and will impact multiple distribution channels for life risk insurance products.

Life Insurance Code of Practice

Following ASIC's 2016 industry-wide review of claims handling in the life insurance industry, the Financial Services Council introduced a Life Insurance Code of Practice. The code, which was effective on July 1, 2017, imposes customer service standards on life insurers. It was designed to protect consumers and imposes standards above current statutory obligations and includes provisions relating to, among other things, sales practices, advertising practices, and minimum standard medical definitions.

A voluntary code is also being developed for life insurance sold through superannuation by the Insurance in Superannuation Working Group. A key objective of this code is "insurance offered on an automatic basis in superannuation must be appropriate and affordable, and must not inappropriately erode retirement income." This code is intended to go into effect on July 1, 2018.

Royal Commission to Investigate Financial Services Sector

In was announced in November that a Royal Commission will be established to investigate "misconduct" in the financial services sector. This will involve a "comprehensive inquiry" that will cover not only banks, but also insurance companies (along with wealth managers and superannuation providers).

The government has established the Royal Commission to give Australians "a greater degree of assurance" about the financial services sector.

The Royal Commission will have 12 months to investigate and will report to the government by February 2019. The Royal Commission will investigate how financial institutions have previously dealt with misconduct and whether these cases expose any issues in terms of cultural and governance issues with respect to the regulation and supervision of the industry.

Further details regarding the Royal Commission are not yet available, but the conduct of the Commission and its findings are likely to have a significant impact on the financial services sector in 2018 and beyond.

New Zealand

New Zealand Insurance Regulation Updates and Pending Reforms

Summary

During 2017, private insurers worked to settle most Kaikoura earthquake claims by the end of the year. This process involved an agreement between private insurers and the Earthquake Commission (EQC) for insurers to manage EQC claims, so as to streamline the process. This has provided a model for future claims handling and speedy settlements of earthquake claims. Along with EQC reforms, the regulation of financial advisers and supervision of insurers doing business in New Zealand all progressed in a measured way, but stalled slightly by a general election in September 2017 which saw an unexpected change of government. The new government may have different priorities in 2018.

Prudential Supervision

Insurers carrying on business in New Zealand must hold a license from, and are supervised by, the Reserve Bank of New Zealand under Insurance (Prudential Supervision) Act 2010. The Reserve Bank is reviewing IPSA, and in 2017, sought submissions from stakeholders on key issues. The Reserve Bank will consider these submissions in 2018 during Phase 2 of the review.

The Reserve Bank sought submissions on the scope of obligations and proportionality to the risks of business being carried out here, how overseas insurers that are sufficiently regulated in their home jurisdiction should do business here, whether statutory funds would provide comfort for life insurance policyholders, whether the enforcement regime is appropriate and incentivizes compliance in a proportionate way, whether distress management is good enough to protect New Zealanders from overseas insurers in financial distress, and the appropriateness of the disclosure regime, especially in comparison to similar industries, such as banking.

After considering the submissions, the Reserve Bank reported in October 2017. Its focus for Phase 2 of the Review is on insurers' requirements for capital to face another catastrophe, monitoring parent insurance companies, licensing, enforcement tools and financial strength ratings. The soundness of the insurance sector has improved, but competition and innovation have not been unduly restricted.

Insurance Contract Law Reform

It is not clear whether a change of government will impact the long awaited proposed reform of insurance laws. In 2017, New Zealand expected a review of the Insurance Law Reform Act along similar lines to the reforms in other countries including the UK. This will include a review of the duty of disclosure as the insurer's remedies for mis-statement and non-disclosure are said to create a power imbalance between insurers and policyholders. The proposed reform, although delayed, is still very much on the cards, and expected to follow once the financial advisor reforms are complete.

New Financial Advice Legislation

Insurance is a financial product for the purpose of the regime regulating financial advice. In its financial audit, the International Monetary Fund encouraged New Zealand to "strengthen or remove the registration-only regime available now to intermediaries."

New Zealand had already started on that mission when the audit report came out in May 2017. By August 2017, the Financial Services Legislation Amendment Bill had been introduced to Parliament. The Bill repeals the Financial Advisers Act and brings provisions into the Financial Markets Conduct Act to regulate financial advice. Two Committees are working on the new regime and one will draft a new Code of Conduct for financial advisers.

The new Code of Conduct should be ready for approval in August 2018. A licensing regime will commence shortly thereafter. The new Code of Conduct will cover advice given from May 2019 with a two-year transition period for the adviser competence requirements.

As currently drafted, the Code of Conduct applies to all regulated financial advice and is far wider than its current scope. It may capture advice activities of authorized financial advisers, registered financial advisers, advice businesses and even "robo-advice." This year saw a startup insurer enter the market with a service managed fully by chat-bots. The Financial Markets Authority has started drafting exemptions from the Financial Advisers Act to enable personalized robo-advice.

The new Code of Conduct should help to provide consistency across all types of financial advice, removing a products distinction and a distinction between personalized and class advice, regulating advice without any occupational codes and framing the regulation through the eyes of the client. The new Code of Conduct is expected to take the form of minimum standards of client care in relation to the agent's competence and knowledge.

Over the next 18 months, the Financial Markets Authority will work with the industry in order to help participants understand and get ready for the new financial advice regime and licensing. All insurers and brokers operating in New Zealand will need to ensure they are complying with the changes and aware of the implications for their business.

Review of Earthquake Commission Act 1993

New Zealand has a national disaster insurance scheme established by the Earthquake Commission Act 1993. A review was announced in 2012 and clarity on its reforms arrived in 2017. The reforms aim to simplify the scheme and help private insurers work together with EQC on earthquake claims, by:

- Increasing the monetary cap from $100,000 (plus GST) to $150,000 (plus GST) for EQC building cover
- Clarifying EQC land cover is for natural disaster damage that directly affects the insured residence or access to it
- Standardizing the claims excess on EQC building cover at $1,000. This currently ranges from $200 to $1,150 depending on the size of the claim
- EQC no longer providing any residential household contents insurance and
- Requiring EQC claimants to lodge claims with their private insurer who would pass the claim on to EQC (if the property is insured)

Before a change of government, the plan was to release a draft reform bill in early 2018.

Fire Service Levy Increases

The New Zealand Fire Services Levy is set to increase in the 2017/18 financial year. This is mostly due to re-structuring fire services in New Zealand for a more streamlined service. To maintain the current level of services, the board of the New Zealand Fire Service Commission is proposing to increase the rates of levy on fire insurance contracts. This followed an amalgamation in July 2017 where the New Zealand Fire Service, National Rural Fire Authority and 38 rural fire authorities became one organization, Fire and Emergency New Zealand.

The legislation and related guidance on how the new levies are to be calculated and applied is complex. During this current transition period, industry participants are finding they need to dedicate resources to understanding the changes and adjusting their systems to accommodate the new regime.

CONCLUSION AND FORECAST

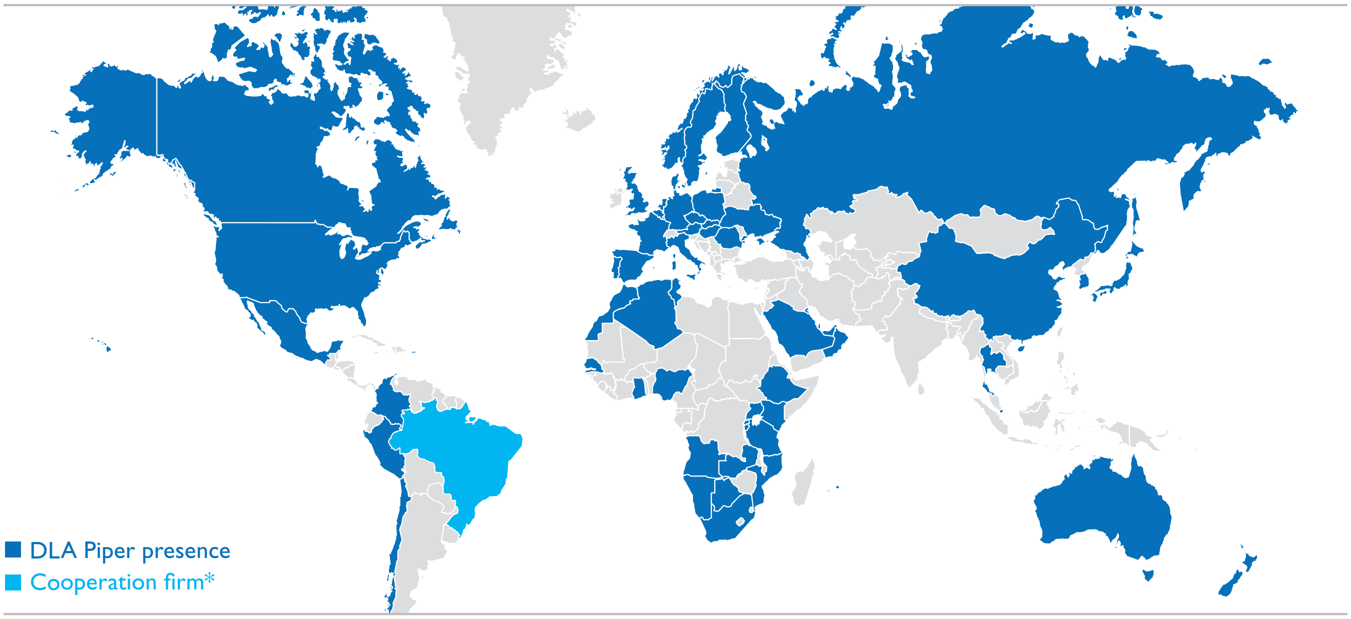
2018 will be a dramatic year for the insurance industry. Geo-political and economic developments will impact the industry. From the devastation towards the end of 2017 and in early 2018, it seems clear that the industry will continue to see an increase in natural disasters. These terrible events, of course, provide the industry with the opportunity to do what it does best, respond and assist policyholders.

In addition, the year will provide an opportunity to reset the regulatory rules for many insures – for better or worse. This includes progress on Brexit, a possible new strategic direction for the IAIS, the implementation of the EU-US covered agreement and other developments. Technology (and with it, new competitors) will also continue to present significant new opportunities and challenges for the insurance sector – and its regulators. As we have seen for the last several years, insurers will continue to hunt for the elusive prizes of top line growth, increased investment yields, operational efficiencies, and improved profitability.

As far as forecasts, we anticipate:

- Brexit will end with a kick of the can down the road.
- There will be no more covered agreements, but there will be a renewed effort by global regulators to increase cooperation and reliance on equally effective regulation.
- Global regulators will increasingly change their focus from capital issues to risk management, market conduct, regulation of technology, and use of data.
- The ghost of legacy business will continue to haunt the performance of insurers and also lead to disposals to a new class of strategic buyers.
- The healthcare and health insurance industry will continue to converge.
- CVS/Aetna will be a harbinger.
- Google, Amazon, and other technology behemoths will make additional moves into the insurance space.
- A serious effort will be made to close the protection gap in response to growing global natural disasters.
- The London insurance market will continue to thrive – and so will Bermuda.

OUR GLOBAL PRESENCE



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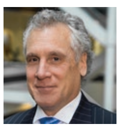
For more information

This publication reflects the work and experience of many within our global insurance team. The principal authors are:

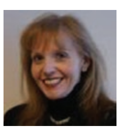

William C. Marcoux
New York
william.marcoux@dlapiper.com


Peter S. Rice
Boston
peter.rice@dlapiper.com

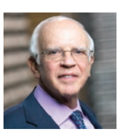

Stephen W. Schwab
Chicago
stephen.schwab@dlapiper.com


Paul Chen
New York and Silicon Valley
paul.chen@dlapiper.com


David Luce
New York
david.luce@dlapiper.com


Kathleen A. Birrane
Baltimore
kathleen.birrane@dlapiper.com


Carla Small
New York
carla.small@dlapiper.com


P. Nicholas Kourides
New York
nicholas.kourides@dlapiper.com


Nick PK Paran
London
pk.paran@dlapiper.com


Melanie James
London
melanie.james@dlapiper.com


George Mortimer
Birmingham
george.mortimer@dlapiper.com


Heng Loong Cheong
Hong Kong
hengloong.cheong@dlapiper.com

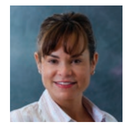

Roy Chan
Shanghai
roy.chan@dlapiper.com


Peter Shelford
Bangkok
peter.shelford@dlapiper.com

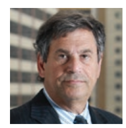

Samantha O'Brien
Brisbane
samantha.obrien@dlapiper.com

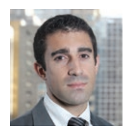

Marcella Hill*
São Paulo
marcella.hill@cmalaw.com


Jim Halpert
Washington, DC
jim.halpert@dlapiper.com


Sydney White
Washington, DC
sydney.white@dlapiper.com


Steven R. Phillips
Washington, DC
steven.phillips@dlapiper.com


Gerald Rokoff
New York
gerald.rokoff@dlapiper.com


Michael Greenberg
New York
michael.greenberg@dlapiper.com


Sophie Devitt
Brisbane
sophie.devitt@dlapiper.com


Magdi Adab
London
magdi.adab@dlapiper.com

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**Marcella Hill is a partner in Campos Mello Advogados, an independent law firm working in cooperation with DLA Piper in Brazil.*