



## Recent Amendments to the Pennsylvania Insurance Holding Company Act New Enterprise Risk Report

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Pennsylvania's Insurance Holding Company Act (IHCA) was recently amended by Act 136, signed into law on July 5, 2012. Act 136 made a number of changes to the IHCA. This Alert discusses the new enterprise risk report that must be filed with the Pennsylvania Insurance Department beginning in 2014. Other aspects of Act 136 are discussed in other Alerts we have issued.

### Enterprise Risk Reporting Requirements

The ultimate controlling person of every domestic insurer that is a member of an insurance holding company system is now required to file an annual enterprise risk report. While neither the IHCA nor Act 136 contain a definition of "ultimate controlling person," the Insurance Department has adopted a regulation defining such person as follows:

A person which is not controlled by another person. An ultimate controlling person may be one or more of the following: individual, corporation, limited liability company, partnership, association, joint stock company, trust, unincorporated organization, or any similar entity or combination of the foregoing who controls another person.

31 Pa.Code §25.1(a) (definition of "ultimate controlling person").

The report must be filed with the Insurance Department if Pennsylvania is the lead state regulator for the insurance holding company system. The enterprise risk report must be filed on an annual basis, commencing no later than March 31, 2014 covering the prior calendar year.

### Content of the Report

The annual enterprise risk report must identify the material risks within the insurance holding company system that pose enterprise risk to the insurer or the insurance holding company system as a whole. Under Act 136, "enterprise risk" is defined as:

An activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, would likely have a material adverse effect on the

financial condition or liquidity of an insurer or its insurance holding company system, including, but not limited to, anything that would:

- (1) trigger a company action level event for the insurer under the applicable risk based capital statutes; or
- (2) cause the insurer to be deemed to be in hazardous financial condition ....

A "company action level event" occurs when an insurer's risk based capital (RBC) falls below a specified capital adequacy threshold. The RBC is calculated pursuant to a formula prescribed in Pennsylvania's insurance laws and standards adopted by the National Association of Insurance Commissioners (NAIC).<sup>1</sup> Under Act 136, insurance holding company systems must now analyze whether any activities, circumstances or events would cause the domestic insurer's RBC ratio to fall below the prescribed RBC level and report on such matters to the Insurance Department.

If a "hazardous financial condition" exists, an insurer may be placed in a receivership proceeding under Article V of the Insurance Department Act of 1921, as amended.<sup>2</sup> A finding of hazardous financial condition may be based upon a broad range of reasons, including, for example:

- (1) Net losses from the insurer's operations during the previous 12-month period that exceed a prescribed threshold;
- (2) Significant increases in premium writing (without regard to ceded reinsurance) if the insurer lacks adequate financial and administrative capacity to meet its obligations as they fall due;
- (3) Material adverse findings relating to the insurer's financial condition as reported by the insurer's external auditors or actuaries;

<sup>1</sup> A company action level event triggers an insurer's obligation to file a RBC plan with the Insurance Department. See 40 P.S. § 221.1-A (definitions) and §221.6-A.

<sup>2</sup> See, e.g., 40 P.S. § 221.14(1) and §221.19.

(4) The insolvency, or threatened insolvency, of an affiliate of the insurer; or

(5) A demonstration of lack of competence, fitness or reputation by the officers, directors or controlling person of the insurer.

See 31 Pa.Code §160.3. Under Act 136, these types of risks to the insurer's financial condition must be analyzed and addressed in the enterprise risk report.

Because Act 136 is a relatively new law, the Insurance Department has not yet adopted requirements governing the form or content of the annual enterprise risk report. However, insurers should anticipate the Insurance Department will adopt a form for the enterprise risk report that is similar to the Form F adopted by the NAIC in 2010. The NAIC Form F requires the enterprise risk report to address the following issues:

- Any material developments regarding strategy, internal audit findings, compliance or risk management affecting the insurance holding company system;
- Acquisition or divestiture of insurance affiliates and reallocation of financial or insurance affiliates within the insurance holding company system;
- Any changes of shareholders of the insurance holding company system exceeding 10 percent or more of voting securities;
- Developments in investigations, regulatory activities or litigation that may have a significant impact on the insurance holding company system;
- Business plans and summarized strategies for the insurance holding company system for next 12 months;
- Identification of material concerns of the insurance holding company system raised by a supervisory college, if any, in last year;
- Identification of insurance holding company system capital resources and material distribution patterns;
- Identification of any negative movement (or discussions with rating agencies that may have caused, or may cause, potential negative movement) in the credit ratings and individual insurer financial strength ratings assessment of the insurance holding company system (including both the rating score and outlook);
- Information on corporate or parental guarantees throughout the holding company and the expected source of liquidity should such guarantees be called upon; and
- Identification of any material activity or development of the insurance holding company system that, in the opinion of senior management, could adversely affect the insurance holding company system.

While the precise extent of the reporting obligation in Pennsylvania under Act 136 has not yet been established, the ultimate controlling person of a domestic insurer should expect it will be required to analyze a broad array of potential risks to the insurer and to submit the required enterprise risk report to the Insurance Department discussing those risks.

### **Withholding Regulatory Approval for Shareholder Dividends by the Insurer**

If the ultimate controlling person does not file the annual enterprise risk report or if any person violates the IHCA in a manner that prevents the Insurance Department from obtaining a full understanding of the enterprise risk to the domestic insurer, then the Insurance Department is authorized to disapprove filings by the insurer seeking regulatory approval to pay shareholder dividends and distributions (collectively, herein, dividends).<sup>3</sup>

Under the IHCA, insurers must notify the Insurance Department at least 30 days in advance of the proposed payment date for an "extraordinary" dividend.<sup>4</sup> The insurer may pay an extraordinary dividend after the 30-day period if the Insurance Department, within the 30-day period, has not disapproved payment of the dividend.<sup>5</sup> 40 P.S. § 991.1405(b)(1). Under Act 136, the Insurance Department is authorized to disapprove an extraordinary dividend filing if there has been non-compliance with the Act 136 requirements regarding enterprise risk reports and procedures.

It appears the Insurance Department's authorization to disapprove dividend filings is limited to requests to pay extraordinary dividends, because the IHCA does not grant the Insurance Department the authority to approve or disapprove "ordinary" dividends.<sup>6</sup> An insurer must report ordinary dividends to the Insurance Department within five business days following the declaration of the dividend and at least 10 days prior to payment of the dividend. 40 P.S. § 991.1404(e). Accordingly, because the Insurance Department is not authorized by the IHCA to disapprove an ordinary dividend, the IHCA may be interpreted as not authorizing the Insurance Department from using non-compliance with the enterprise risk requirements of Act 136

<sup>3</sup> The disapproval of dividends is in addition to other sanctions the Insurance Department may seek or levy for non-compliance with the requirements. See e.g., 40 P.S. § 991.1410(f).

<sup>4</sup> An "extraordinary" dividend is a dividend that, together with other dividends paid during the preceding 12 months, exceeds the greater of: (i) 10 percent of the insurer's policyholder surplus as shown on its last filed annual statement; or (ii) The net income of the insurer for the period covered by the last filed annual statement, not including any pro rata distribution of any class of the insurer's securities. 40 P.S. § 991.1405(b)(2).

<sup>5</sup> An extraordinary dividend may also be paid if the Insurance Department approves the payment within the 30-day period.

<sup>6</sup> An "ordinary" dividend is any dividend that is not extraordinary.

as a basis to forbid an insurer from paying ordinary dividends. However, other sanctions can be sought or imposed by the Insurance Department for non-compliance with the enterprise risk requirements. *See e.g.* 40 P.S. §§ 991.1406(d) and 991.1410.

### Examination of Books and Records and Affiliates

Under Act 136, the Insurance Department is authorized to order a domestic insurer to produce its own books and records, and books and records in the possession of its affiliates, if such materials are reasonably necessary to ascertain, *inter alia*, the enterprise risk to the insurer. Additionally, the Insurance Department may order an insurer to produce information that is not in the possession of the insurer if the insurer can obtain access to the information pursuant to a contractual relationship, statutory obligation or other method. If the insurer cannot obtain the information requested by the Insurance Department, the insurer must explain the reason(s) the information is not obtainable and identify the person that possesses the requested information.

If the insurer fails to comply with an order issued by the Insurance Department to produce the books and records, the Insurance Department is authorized by Act 136 to examine the insurer's affiliates to obtain the information. The Insurance Department also has the power to issue subpoenas and examine under oath any person as to any matter pertinent to determining the enterprise risk to the insurer. The costs for any such examination, including expenses incurred by the Insurance Department in engaging attorneys, actuaries, accountants or other experts, may be assessed upon the insurer.

### Required Statements in Form A

Under the current IHCA, a person seeking to acquire a controlling interest in a domestic insurer must file a statement, commonly known as a "Form A," with the Insurance Department, seeking regulatory approval of the acquisition. Under Act 136, the acquiring party must now include two required statements in the Form A, as follows:

- An agreement by the acquiring person that the acquiring person will provide the annual enterprise risk report as long as the acquiring person has control of the domestic insurer; and
- An acknowledgment by the acquiring person that the acquiring person and subsidiaries it controls will provide information upon request to the Insurance Department as necessary for the Insurance Department to evaluate enterprise risk to the domestic insurer.

Although the filing requirements for the enterprise risk report are not applicable until March 31, 2014, for the 2013 calendar year, this section of Act 136 is effective September 3, 2012. Therefore, Form A filings on or after September 3, 2012 will be required to contain the two required statements regarding enterprise risk.

### Public and Regulator Access to Filings

The enterprise risk report and any examinations relating to enterprise risk are protected from public disclosure under Pennsylvania's Right-to-Know Law. Because Form A filings are not protected under the Right-to-Know Law, the enterprise risk statements in the Form A are not protected from public disclosure.

Act 146 authorizes the Insurance Department to share information obtained under the IHCA, including enterprise risk reports, with insurance regulators in other states, law enforcement officials in Pennsylvania or other jurisdictions, the International Association of Insurance Supervisors, the NAIC, and members of any supervisory college.

### Conclusion

Individuals and entities who are the ultimate controlling person(s) of an insurers whose lead regulator is Pennsylvania should develop and refine the necessary practices and procedures so a thorough analysis of the enterprise risk to the insurer and the entire insurance holding company system can be undertaken in a timely manner, in advance of the March 31, 2014 due date for the filing of the first annual enterprise risk report.

This Alert discusses only some of the changes made by Act 136. Because these changes are new, and no regulatory guidance or regulations have been issued as yet, the interpretations of the new statutory requirements as discussed herein are subject to change.

The attorneys in our Corporate and Regulatory practice group are available to provide assistance with respect to specific transactions regulated under the IHCA or otherwise providing advice on the changes to the IHCA enacted by Act 136. Please feel free to contact Linda Kaiser Conley or James Potts for advice and assistance.

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*To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact:*

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