PAUL HASTINGS

An Eye on Insurance

Recent Developments in Insurance Regulation

Overview

Recent months have seen a significant burst of activity by state insurance regulators and the National Association of Insurance Commissioners (the "**NAIC**") involving the adoption of major revisions to the regimes governing investments by insurers and the use of artificial intelligence in the conduct of insurance business. It is no exaggeration to say that these changes represent some of the most seismic shifts seen to these regimes in the past decade (and, in the case of the investment law regime, since the 1990s).

While the full ramifications of the new measures remain to be seen, actors who are in any way subject to U.S. insurance regulation should closely review these recent changes to ensure their own compliance with them. We summarize below the key elements of these changes. If helpful, we would be happy to consult with you or your team to determine which actions you should consider taking in response to the changes discussed in this Bulletin.

Principal Proponents of Recent Changes

Many of the changes to the insurance investment regime discussed in this Bulletin were driven by committees or subgroups within the NAIC. (By way of background, the NAIC is a standard setting and regulatory support organization governed by the chief insurance regulators of the 50 U.S. states, the District of Columbia, and five U.S. territories.) In particular, the following have been the principal drivers of these recent changes:

- The NAIC's Financial Condition (E) Committee ("**Financial Condition Committee**"), which coordinates the financial aspects of NAIC standard setting and is composed of approximately 38 subgroups, including:
    - The Statutory Accounting Principles (E) Working Group ("**SAPWG**"), which is responsible for developing and maintaining the statutory accounting principles ("**STAT**" or "**SAP**") that govern financial reporting by insurance companies;
    - The Valuation of Securities (E) Task Force ("**VOSTF**"), which is responsible for the NAIC's credit assessment process for securities owned by insurance companies; and
        - VOSTF also oversees the Securities Valuation Office ("**SVO**") and Structured Securities Group ("**SSG**"), which, together with the Capital Markets Bureau, constitute the NAIC Investment Analysis Office ("**IAO**");
    - The Risk-Based Capital Investment Risk and Evaluation (E) Working Group ("**RBC WG**"), which oversees the RBC investment framework for all business types.

In connection with the insurance investment regime, state insurance regulators have largely played an observer role and have been content to permit subgroups within the NAIC to take the lead in advancing proposed revisions. By contrast, in the context of the regulation of the use of artificial intelligence, the state regulators have been much more active and have largely directed the adoption of the latest restrictions on the use of artificial intelligence, as we discuss below.

Continuing Evolution of the Insurance Investment Regime

The NAIC Summer National Meeting saw the adoption or proposal of a number of major changes to the regulatory regime governing the investments that insurers are permitted to make, in many cases building off a general trend towards overhauling this regime that has gathered steam since 2022. The major engines for these changes have been the SAPWG and VOSTF, and accordingly, the discussion below focuses largely on changes driven by each of these NAIC subgroups.

Changes Driven by SAPWG

Exposure of Proposal to Allow Debt Securities Issued by Certain Unregistered Funds to Qualify as Issuer Credit Obligations

In August 2023, the NAIC adopted a new, principles-based bond definition, which substantially narrowed the range of securities that could be treated as bonds for statutory accounting purposes. The new definition – which becomes effective on January 1, 2025 – provides that all bonds will need to qualify as *either* issuer credit obligations ("**ICOs**")[1] *or* asset-backed securities ("**ABS**"),[2] and sets forth how debt securities that fail to qualify as bonds are to be treated.

Under the adopted definition, debt securities issued by business development corporations, closed-end funds, or similar operating entities qualify to be treated as ICOs – and, consequently, qualify for bond treatment – *only* if the issuer is registered under the Investment Company Act of 1940 (the "**'40 Act**"). In contrast, debt securities that are issued by unregistered funds *do not* qualify as ICOs; the only way for these securities to receive bond treatment is by satisfying the requirements to qualify as ABS. These include additional requirements that to which ICOs are not subject: specifically, they must have substantive credit enhancement, and they must have underlying collateral that consists of either financial assets or cash-generating non-financial assets.

After receiving feedback that the use of '40 Act registration as the determining factor for bond treatment was inconsistent with the principles-based approach of the adopted bond definition, the SAPWG on January 10, 2024 exposed for comment a proposed revision to the definition that would have permitted debt securities issued by unregistered funds to be classified as ICOs, rather than ABS, if the fund qualified as an "operating entity." The objective of this proposed revision was to allow debt leverage issued by unregistered funds to receive similar treatment to debt leverage issued by '40 Act-registered funds.

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[1] ICOs represent the debt of operating entities (or their holding companies) that have a purpose other than the pass-through of investment proceeds.

[2] ABS represent debt issued through the securitization of financial assets or cash generating non-financial assets. There are two defining characteristics that must be present in order for a security to meet the ABS definition: (1) the assets collateralizing the debt issuance are expected to be the primary source of cash flows for repayment of the debt; and (2) securitization of the assets collateralizing the debt issuance redistributes the credit risk of the financial assets, such that the creditor is in a different position than if the underlying collateral were held directly.

However, some comments received to this proposed revision suggested that rated feeder notes and collateralized fund obligations could qualify as ICOs under the proposed revisions. The SAPWG reacted negatively to these suggestions, and opted instead to further refine the proposed definition revision (focusing in particular on reexamining the definition of an operating entity) and to better define the amount of debt that operating entities could issue and still have the debt be treated as an ICO.

On August 13, the SAPWG reviewed a new proposed revision to the principles-based bond definition.[3] The revised proposal conceptually confirmed that debt securities issued by funds that qualify as operating entities will be treated as ICOs, regardless of whether or not the fund is registered under the '40 Act. However, under the revised proposal, while '40 Act-registered funds are automatically considered operating entities and are allowed to issue debt up to the limits permitted by the '40 Act, there is no comparable safe harbor for unregistered funds. Unregistered funds can only qualify as operating entities if they have "a primary purpose of raising equity capital and generating returns to equity investors."

The revised proposal was drafted in coordination with interested parties and has been exposed for comment until September 6, 2024. We expect the SAPWG to adopt this revised proposal shortly thereafter.

Exposure of Proposal to Require Bifurcation for "Credit Repacks" and Other Derivative Wrapper Investments

On August 13, the SAPWG received reports that a number of inquiries had been received regarding how "credit repack" structures should be treated in light of the principles-based bond definition. "Credit repack" structures involve the acquisition of a debt security by a special purpose vehicle which then reprofiles the cash flows by entering into a derivative transaction with a derivative counterparty.

After considering the intent behind the principles-based bond definition, the NAIC staff reported their view to the SAPWG that a "credit repack" transaction could qualify as an ICO – and, consequently, a bond – if the impact of the repacking was merely to convert fixed payments to floating payments or to change as the currency denomination of payments. However, the staff's view was that if the timing or amount of cash flows were to be altered in other ways, it would be unlikely that these structures could receive bond treatment, as they could not qualify as ICOs and would be unable to satisfy the ABS requirements, as these structures do not provide for substantive credit enhancement.

After reviewing the NAIC staff's feedback, the SAPWG voted to expose for comment until September 27, 2024 revisions to *SSAP No. 86 (Derivatives)*.[4] Rather than focusing solely on "credit repacks," the exposed revisions address all debt security instruments with derivative wrappers (or similar components) and require that the derivative and the underlying debt security receive separate accounting treatment (referred to as "bifurcation"). While these revisions deviate from current statutory accounting guidance, which explicitly precludes the separation of embedded derivatives, they reflect the staff's view that bifurcation is preferable to an outcome that would preclude bond treatment altogether for certain types of repacks.

[3] https://content.naic.org/committees/e/statutory-accounting-principles-wg

[4] See FN. 3.

Accordingly, the proposed revisions split the statutory accounting assessments of the two main elements of debt security repack structures, with the result that the underlying debt security would be assessed under the principles-based bond definition to determine whether the security qualifies for bond treatment, while the derivative would be separately assessed under SSAP No. 86 and reported on Schedule DA. As a result, there would be no statutory accounting benefit or burden if an investor engages in a repack transaction. The NAIC staff also expressed the hope that this proposal would provide state insurance regulators with greater visibility into derivatives used by insurers and enhance the ability of the regulators to monitor such structures.

The revisions only narrowly permit bifurcation, in that one can look only at the underlying debt security to determine if such security receives bond treatment. In all other respects, including determining the name of issuer, NAIC credit designation, investment yield, and other investment characteristics, the repacked security will not be separated out into its constituent components. Further, structured notes (which do not provide principal protection) would be excluded from the proposed bifurcated treatment, since they do not qualify as bonds and are treated purely as derivatives under SSAP No. 86.

Exposure of Proposal to Require Asset-level Reporting of Funds Withheld and Modco Assets

The Interest Maintenance Reserve Ad Hoc Group of the SAPWG was formed in 2023 to address the issue of net negative interest maintenance reserves for life insurers. This subgroup has specifically assessed that it can be difficult for regulators to identify assets that are subject to funds withheld or modified coinsurance (“modco”) arrangements within insurers’ financial statements and reporting schedules. Based on this assessment, the SAPWG began consideration of proposed methods to update reporting in insurer financial statements to allow for easier identification of assets that are subject to funds withheld or modco arrangements. As these arrangements are also germane to property and casualty insurers, the methods considered would add reporting to the annual statement blanks for most types of insurers (not just life insurers).

On August 13, the SAPWG exposed for comment until September 27, 2024 a proposal to add a new part to Schedule S in the Life/Fraternal and Health annual statement blanks and a new part to Schedule F in the Property/Casualty (P/C) and Title annual statement blanks that insurers would use to report all assets held under a funds withheld arrangement and a separate signifier for modified coinsurance assets. [5] Such assets would be reported at the CUSIP-level, but would not be tied to specific reinsurance treaties, as concerns were expressed regarding the potential disclosure of proprietary information.

Resources Relating to Principles-Based Bond Definition

As noted above, the principles-based bond definition will go into effect on January 1, 2025. In anticipation of this, the SAPWG has adopted Statutory Issue Paper No. 169, which details the conceptual background for the revisions made to SSAP No. 26—Bonds, SSAP No. 43—Loan-backed and Structured Securities (renamed Asset-Backed Securities), SSAP No. 21—Other Admitted Assets, and certain other SSAPs in connection with the principles-based bond definition.[6] While this statutory issue paper does not provide binding guidance, it does include important context regarding how the final form of the definition was reached and the intent underlying its formulation. The SAPWG also voted to expose until September 27, 2024 an Implementation Question and Answer Guide (dated August 7, 2024) that answers questions regarding the implementation of the

[5] See FN. 3.

[6] See FN. 3.

new definition.[7] It is expected that this Q&A guide will be expanded over time as new questions arise.

Changes Driven by VOSTF

Establishment of a Process to Replace a CRP Rating of a Security With an IAO-Determined NAIC Designation

In 2023, the VOSTF exposed for comment a proposal that a level of discretion be provided to the SVO to review and possibly replace ratings issued by NAIC-recognized credit rating providers ("**CRPs**") for securities, ostensibly to address "blind reliance" on credit ratings.[8] Previously, many bond investments were considered to be "filing exempt," meaning that they automatically received an NAIC designation equivalent to their credit rating from an NAIC recognized credit rating provider.

This proposal met with intense concern from the industry and, through coordinated efforts of interested parties, was repeatedly revised, primarily to add checks on the ability of the NAIC and its subgroups to overrule CRPs and, further, to ensure that an appeal process would exist to enable insurers to make their case for maintaining the CRP rating for their investments.

The final proposal, as adopted, establishes the following procedures for the removal of an eligible CRP rating of a specific security from filing exemption:

- Initiation of the Process: The review of a security may be initiated by either a state insurance regulator or the IAO staff if they believe that the NAIC designation category assigned through the filing exemption based on a CRP rating "may not be a reasonable assessment of investment risk of the security for regulatory purposes."

- Decision to Proceed: Following the initiation of the process, the credit committee of the IAO (the "**IAO Credit Committee**") will meet to decide whether it takes the view that the NAIC designation category assigned through the filing exemption based on a CRP rating is a "reasonable assessment of investment risk of the security for regulatory purposes."

  As part of its determination, the IAO Credit Committee may take into account: (i) a comparison to peers rated by different CRPs; (ii) consistency of the security's yield at issuance or current market yield to securities with equivalently calculated NAIC designations rated by different CRPs; (iii) the IAO's assessment of the security applying available methodologies; and (iv) any other factors it deems relevant.

  If the IAO Credit Committee's determination is that the NAIC designation category assigned through the filing exemption based on a CRP rating is not a "reasonable assessment of investment risk of the security for regulatory purposes," then the security will be placed under full review, designated in NAIC systems with the symbol "UR" and an information request will be initiated. If the IAO Credit Committee's opinion is that the assigned NAIC designation category is likely a reasonable assessment of investment risk of the security for regulatory purposes, no further action will be taken at that time.

[7] See FN. 3.

[8] https://content.naic.org/committees/e/valuation-securities-tf

- Obtaining Information for Full Review: Following the IAO Credit Committee's determination, the IAO will issue an information request to each insurer that holds the security, in which each insurer is asked to provide the information, including its own internal investment analysis of the security, that would be required if it was filing the security with the SVO. Insurers must respond to this request within 45 days, though they may request that this period be extended for up to 45 additional days. The IAO may contact the insurers' domiciliary regulators for assistance after the initial 45 days if there has been no meaningful response. If the requested information is not provided to the IAO within 90 days, then the security will be removed from filing exemption.

- Provision of Additional Information: At any time during the information request submission period or during the IAO's subsequent analysis of the security, insurers may provide additional information to the IAO. This information may include elements such as presentations from the issuer, and meetings with the issuer's management team.

- Provision of IAO Analysis: Upon satisfactory receipt of the information through the information request, the IAO will perform a full analysis of the security. After it conducts its full review, the IAO must provide the relevant insurers with a written summary of its analysis, specifically discussing why it believes the CRP's risk assessment is an unreasonable assessment of investment risk of the security for regulatory purposes. At this time, the insurers will have an opportunity to respond and to ask questions about the IAO's analysis. The insurers may also invite other authorized parties that have agreed to the NAIC's confidentiality provisions (including CRP representatives) to participate in these discussions with the IAO.

- Materiality Threshold for Final Analysis: Upon completion of the IAO's analysis, the IAO Credit Committee will reconvene to determine its own opinion of the NAIC designation category while taking into account this analysis. The IAO Credit Committee will then determine whether the NAIC Designation Category assigned through the automated filing exemption process is materially different from its own assessment of the security's risk.

  The IAO may proceed to a final analysis only if the Credit Committee determines, based on its review, that the IAO's assessment is *three or more notches different* from the NAIC designation category determined by the eligible CRP credit rating.

- Final Analysis: If the IAO Credit Committee determines that the three-notch materiality threshold is met, the VOSTF chair will create a VOSTF subgroup to review the findings of the IAO. A call will be scheduled with this subgroup at which both the IAO and the insurers who hold the security will be able to make their case with respect to retaining or removing the security from filing exemption. The IAO is required to submit its position in writing and its supporting rationale in advance of that meeting. The domestic state regulators of the insurers will be invited to participate in that meeting. The insurers may also invite other authorized parties that have agreed to the NAIC's confidentiality provisions (including CRP representatives) to participate. After hearing both sides, the VOSTF subgroup will decide whether or not it agrees with the IAO Credit Committee's view.

- Final Decision: If the VOSTF subgroup agrees with the IAO Credit Committee's opinion, the security will be removed from filing exemption, and the IAO's determination of the NAIC designation category will be entered in the NAIC's systems with an analytical symbol of "ER." However, if the security has (or subsequently receives) one or more *other* eligible NAIC CRP ratings that have not been removed, then it can receive its NAIC designation category through the filing exemption process based on those other NAIC CRP ratings that have not been removed. In addition, an insurer may request the IAO to reevaluate an eligible NAIC CRP rating for reinstatement after its removal by filing an appeal with the SVO in a subsequent filing year.

Decisions will be published by the IAO within 45 days of a security being removed from filing exemption via an anonymized summary of “each unique situation encountered” on an insurer-accessible web location. The anonymized summary will not include references to specific securities, CRPs, or impacted insurers. The IAO will also publish an annual anonymized summary of actions taken to remove filing exemption during the prior calendar year.

This process will not go into effect until January 1, 2026, to allow time for the NAIC systems to be modified to handle the IAO review process and the potential removal of filing exemption and substitution of an IAO-determined NAIC designation category. The intention of the VOSTF is that this process be used sparingly, as reflected in the adopted text itself, which states “[t]he process in this section will be consistently applied to all CRPs without favor to any individual CRP or class of CRPs, and is not expected to be used often.”

There remains concern from some quarters that CRPs do not have a sufficient role in the process outlined above, with some commentators urging that the participation of CRPs not be at the discretion of the insurers, but instead that CRPs should be informed at the outset of the IAO review process, should be provided with all materials generated by the IAO, and should have a right to participate in the review process whether or not requested by the insurers. In addition, at the NAIC meeting, one commentator noted that, under the adopted process, an insurer could decide not to participate in or contest an IAO review, and to simply allow the IAO’s assessment to replace the CRP rating if it assessed that the impact of the change was not sufficiently material to warrant the time and expense involved. The commentator noted that, if the insurer made such a decision, then the CRP would have no opportunity to present its case in defense of its rating.

It is possible (but not certain) that these concerns will spur the NAIC to revise the VOSTF adopted process. However, as the adoption of this process was ratified by the VOSTF’s parent committee (the Financial Committee) on August 29, 2024, it is unclear if revisions will occur in the near future.

Amendment of the Definition of an NAIC Designation

NAIC designations, which are symbols utilized by the SVO to denote a category or band of credit risk (e.g., the likelihood of repayment in accordance with a written contract) for an issuer or for a security, are extremely important to insurers in light of their use in determining the risk-based capital (“**RBC**”) factors associated with the fixed-income investments of insurers. Many states have directly incorporated into their investment law regimes quantitative limitations on insurers’ investments in securities with designations below NAIC-3. Historically, NAIC designations have been considered as similar to credit ratings, and a significant majority of fixed-income securities held by insurers are filing-exempt (which means that such securities automatically receive an NAIC designation equivalent to the rating assigned by a CRP).

VOSTF previously exposed, and has now voted to amend, the definition of an NAIC designation, including, crucially, to clarify that an NAIC designation focuses on “investment risk” as distinguished from “credit risk.” “Investment risk” is defined as “the likelihood that an insurer will receive full and timely principal and expected interest.” “Credit risk,” by contrast, “traditionally focuses on the ability of an issuer to make payments in accordance with contractual terms.”[9] In justifying this change, the

[9] See FN. 8, above.

text of the new definition specifically cites principal protected securities ("**PPS**") and SVO-designated funds as examples of where "focusing on credit risk alone would limit the SVO's ability to appropriately assess certain risks."

Other Investment-Related Matters

- The Financial Condition Committee exposed for comment a draft request for proposal for a consultant to design and help implement a new process under which the NAIC would develop "a strong due diligence program" over the ongoing use of CRPs.

- The Financial Condition Committee also exposed for comment responses to comments received on its draft Framework for Regulation of Insurer Investments, which is still under revision.

- The RBC WG voted to begin developing a comprehensive proposal to ensure the consistent treatment of funds that have underlying debt, rather than equity, characteristics, and to qualify those funds to receive NAIC designations and be eligible to receive bond RBC factors.

New York's New Artificial Intelligence Regime

On July 11, 2024, the New York Department of Financial Services ("**NYDFS**") issued a circular letter (the "**AI Guidance**")[10] addressing the use of external consumer data and information sources ("**ECDIS**") and artificial intelligence systems ("**AIS**") in insurance underwriting and pricing. The AI Guidance sets out requirements that the NYDFS will seek to impose on the development and use of predictive models, with particular focus on ECDIS and AIS. Specifically, the AI Guidance requires insurers to:

- analyze ECDIS and AIS for unfair and unlawful discrimination;

- demonstrate the actuarial validity of ECDIS and AIS;

- maintain a governance framework for oversight of the overall outcomes of the insurers' use of ECDIS and AIS; and

- demonstrate appropriate levels of transparency, risk management, and internal controls, including with respect to third-party vendors and consumer disclosures.

Extent of Coverage

The AI Guidance generally applies to all risk-bearing entities authorized to write insurance in the State of New York, including: persons that generally meet the definition of "insurer" under New York law; Article 43 Corporations (i.e., not-for-profit corporations providing medical expense indemnity, dental expense indemnity, hospital service or health service); health maintenance organizations; licensed fraternal benefit societies; and the New York State Insurance Fund (collectively referred to in this Bulletin as "insurers").

[10] https://www.dfs.ny.gov/industry-guidance/circular-letters/cl2024-07. A draft of the AI Guidance was previously released by the NYDFS on January 17, 2024 for public comment. The issued AI Guidance incorporates the NYDFS's responses to and consideration of such comments.

Fairness Principles

The AI Guidance requires that insurers adhere to certain fairness principles in the use of ECDIS or AIS for insurance underwriting and pricing, specifically:

- The data source or model supporting the ECDIS or AIS must not use, and must not be based in any way on, any class protected pursuant to Article 26 of the New York Insurance Law (which specifically prohibits discrimination on certain stated bases);
- The use of the ECDIS or AIS must not result in or permit any unfair discrimination or otherwise violate the New York Insurance Law;
- Any ECDIS to be used must be supported by generally accepted actuarial standards of practice and based on actual or reasonably anticipated experience;
- Any ECDIS to be used must not be prohibited by the New York Insurance Law;
- An evaluation must be conducted as to whether any ECDIS to be used serves as a proxy for any protected classes that may result in unfair or unlawful discrimination and, if correlations are identified, a determination must be made whether use of such ECDIS is required by a legitimate business necessity; and
- The ECDIS or AIS must not collect or use criteria that would constitute unfair or unlawful discrimination or an unfair trade practice.

Comprehensive Assessment for Discrimination

Before they may use ECDIS or AIS in insurance underwriting and pricing, insurers are required by the AI Guidance to conduct a comprehensive assessment to prove that such use would not be unfairly or unlawfully discriminatory under the New York Insurance Law. The assessment must follow a specific three-step process:

- Step I: The insurer must assess whether the use of ECDIS or AIS would produce disproportionate adverse effects in underwriting and/or pricing on similarly situated insureds or insureds of a protected class.
- Step II: If there is a *prima facie* showing of a disproportionate adverse effect, then a further assessment must be conducted to determine whether there is a legitimate, lawful, and fair explanation or rationale for that effect. If no such explanation or rationale can be determined, then the insurer must modify its planned use of ECDIS or AIS.
- Step III: Even if a legitimate, lawful, and fair explanation or rationale exists, the insurer must conduct and document a search for less discriminatory alternative variables or methodology that would still reasonably meet the insurer’s business needs, and thereafter continue to conduct a search for less discriminatory alternatives at least annually.

In addition to being conducted before any use of ECDIS or AIS, the above-described assessment must be conducted at a “regular cadence thereafter” and after material updates to the insurer’s systems. Further, insurers must appropriately document the processes and reasoning behind their testing methodologies and analysis, as part of which, the AI Guidance permits the inclusion of a

description of testing conducted at least annually to assess the output of AIS models, including drift that may result from the use of machine learning or other automated updates. The AI Guidance recommends that insurers use multiple statistical metrics in evaluating data and model outputs, including: adverse impact ratio; denials odds ratios; marginal effects; standardized mean differences; Z-tests and T-tests; and drivers of disparity.

Governance and Risk Management Framework

The AI Guidance, noting that New York Insurance Regulation 215 currently requires an insurer to have a corporate governance framework that is appropriate for the nature, scale, and complexity of the insurer, sets out key expectations as to how that framework should manage concerns around use of ECDIS and AIS. The AI Guidance specifically requires that the framework:

- provide appropriate oversight of the insurer’s use of ECDIS and AIS, including at board and senior management levels;
- include written policies and procedures that clearly define appropriate roles and responsibilities, outline monitoring and reporting requirements, provide for training of relevant personnel and set standards for the acquisition, use of, or reliance on ECDIS and AIS developed or deployed by third-party vendors;
- provide for annual review of all relevant policies and procedures by the insurer’s board of directors, or committees thereof, or senior management;
- provide for an internal audit function that is appropriately engaged with the insurer’s use of ECDIS and AIS, consistent with the financial, operational, and compliance risk;
- include appropriate procedures and resources for maintenance of comprehensive documentation regarding the insurer’s use of ECDIS or AIS; and
- establish a system for receiving and addressing consumer complaints and inquiries about the insurer’s use of ECDIS and/or AIS.

The AI Guidance places direct responsibility for “day-to-day implementation of the insurer’s development and management of ECDIS and AIS” on the senior management of insurers. Senior management can demonstrate to the NYDFS that they are appropriately discharging that responsibility by:

- establishing adequate policies and procedures, assigning competent staff, overseeing model risk management, ensuring effective challenge and independent risk assessment, reviewing internal audit findings, and taking prompt remedial action when necessary; and
- ensuring that all relevant operational areas are appropriately engaged, such as through across-functional management committee with representatives from key function areas, including legal, compliance, risk management, product development, underwriting, actuarial, and data science, as appropriate.

Use of Third-Party Vendors

Even where ECDIS or AIS utilized by insurers was developed or deployed by third-party vendors, the AI Guidance places the ultimate responsibility on the use of that ECDIS or AIS on the insurers themselves. While insurers are required to incorporate appropriate policies and procedures regarding use of third-party ECDIS or AIS into their governance and risk management framework, the AI Guidance imposes two additional, separate requirements on the use of models developed or deployed by third-party vendors.

- *First*, insurers are required to maintain procedures for reporting any incorrect information to third-party vendors for further investigation and update, as necessary, and to remediate and eliminate incorrect information from their AIS that the insurer has identified or has reported to a third-party vendor.
- *Second*, where appropriate and available, insurers should include terms in their contracts with third-party vendors that (i) provide audit rights or entitle the insurer to receive audit reports by qualified auditing entities, and (ii) require the third-party vendor to cooperate with the insurer regarding regulatory inquiries and investigations related to the insurer's use of the third-party vendor's product or services.

Transparency

The AI Guidance also establishes certain expectations for insurers around transparency, emphasizing that the failure adequately to disclose to an insured or potential insured any specific reason or reasons for its refusal of coverage, limitation of coverage, or imposition of a different rate for coverage may be deemed an unfair trade practice. The AI Guidance requires that, when an insurer is using ECDIS and/or AIS, notices regarding an adverse underwriting or pricing decision include:

- the specific source of the information upon which the insurer based its decision;
- whether the insurer uses AIS in its underwriting or pricing process;
- whether the insurer uses ECDIS; and
- a description of the process for the insured or potential insured to request information about the specific data that resulted in the decision.

Failure to disclose this information could constitute an unfair trade practice under Article 24 of the New York Insurance Law, and an insurer may not rely on the proprietary nature of a third-party vendor's algorithmic processes to justify the lack of specificity in such an adverse decision notice. Further, to the extent that an accelerated underwriting process is available only to certain persons, an insurer must disclose the objective criteria for using the accelerated process in writing in a clear and prominent manner in all relevant advertisements and marketing materials, and in disclosures provided to consumers during an application process. In addition, if the accelerated process determines that an applicant will not be approved for insurance under the accelerated process, and can only obtain insurance by submitting to the traditional underwriting process, the reason for such a decision must be disclosed to the applicant within 15 days of such determination.

Other Related Actions

While the AI Guidance currently represents the most expansive regime imposed by any state insurance regulator on the use of ECIS and AIS by insurers, other jurisdictions continue to evaluate the adoption of similar frameworks. As we have previously reported, on September 21, 2023, the Colorado Division of Insurance adopted a first-of-its-kind regulation establishing governance and risk management requirements for life insurers that use ECDIS or algorithms or predictive models that use ECDIS. Similarly, other states have proceeded with the adoption of the model bulletin regarding the “Use of Artificial Intelligence Systems in Insurance” adopted by the NAIC in December 2023. Accordingly, we expect the adoption of further measures by state insurance regulators governing the use of artificial intelligence in insurance.

***An Eye on Insurance** is Paul Hastings LLP’s quarterly discussion on developments in the insurance industry. For an in-depth discussion of any of the subjects raised in this Bulletin, please reach out to sanjivtata@paulhastings.com.*

Paul Hastings LLP’s Insurance practice has a comprehensive understanding of virtually all aspects of insurance regulation and has decades of collective experience in insurance and reinsurance industry transactions. For any questions about developments in the insurance industry, please reach out to the leaders of the Insurance practice.

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