MEMO

DATE: October 17, 2000

TO: Susan Taylor, NAIC Staff to RBC Task Force

FROM: Bill Weller, Chair AAA Joint RBC Task Force

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SUBJECT: 2001 RBC Formulas - Tax Effects of Codification

For the year 2001, the Total Adjusted Capital and RBC Required Capital will be affected by changes reflecting new statutory accounting principles (codification). While the Academy's Life RBC Working Group has been reviewing the development of the factors for both assets and liabilities to recommend changes to better reflect the new approach to taxes in statutory accounting, this work may or may not be finalized in time for the 2001 formula. As we understand them, there are two time deadlines:

1. Lines and programming changes - any changes which require programming of new lines of new calculations need to be approved in December, 2000.
2. Factor and instruction changes - changing an existing factor or revising the instructions for the company input needs to be approved in March or June depending on the willingness of various Working Groups.

During the Life RBC Working Group conference call, and later supported by the MCO-RBC Working Group, there is a desire to provide lines and programming sufficient to allow any or all of the following options:

- Total or partial "non-admission" of DTAs or DTLs in the calculation of Total Adjusted Capital (TAC).
- More consistent treatment of tax offsets throughout the formula, possibly (but not necessarily) at the back end of the formula (just before or after application of covariance). Conceivably this would be in conjunction with a change of the current individual risk factors to a pre-tax basis, for those factors not already on that basis.
- Incorporation of a sensitivity test[1], to show how a company's RBC ratio would change if tax offsets or DTAs were not available.

Note that, while the first bullet above (DTAs, DTLs) is due to the implementation of codification, the second (tax offsets) is an issue that has existed since the development of the RBC formulas. Even though the tax offset issue is not altogether new, the NAIC may wish to address it simultaneously with the DTA/DTL issue. The following structural changes for 2001 would allow for the various options.

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[1] At this time sensitivity tests are only part of the Life RBC formula completion. They provide additional information but do not impact of the ratio or the potential for an "RBC event."

DTAs, DTLs

Two additional lines would be added at the end of the current (2000 version) calculation of TAC. One line would ask the company to fill in the Net DTA and the other would ask for the Net DTL. Programming would apply a factor to each of these and the Final TAC would be the current "final amount" less the adjustment (DTA X factor and/or DTL X factor). The factors, decided at a later NAIC meeting, could equal 1.0, 0.0 or something in between. This allows full flexibility in the calculation of TAC relative to DTAs and DTLs. The NAIC will need to decide the level of connection between changes to the TAC and changes to the RBC Required Capital that can be implemented for 2001. It is recognized that, for the most part, we cannot estimate the impacts on companies prior to the annual statements in 2001.

Tax offsets

Three alternatives have been developed to accomplish this aspect of the goal that are consistent with the AAA's Life RBC Task Force recommendations presented in September.

The first approach adds a single line just prior to the calculation of covariance[2]. The risk factors themselves would be grossed-up (from factors used in 1999) where necessary to become pre-tax. The single line would be the tax adjustment. If necessary, the single line could include a calculation (needed by December) where each of C-1, C-2 etc. values in the RBC summary page (e.g. LR025) would be adjusted to an after tax value. This approach assumes for the interim (i.e. 2001) that all C-1 values are Capital Gains & Losses risks, C-2 are all Ordinary Income risks, etc. For later years, the C-1 values could be separated into G&L vs Ordinary Income portions.

The second approach adds two columns to each line in the final RBC sheets (e.g. LR025) prior to the covariance calculation. One column would be a tax factor (values not needed in December) and the other column would show the result of the multiplication of the pre-tax (or current) RBC requirement times the tax factor. This would allow, for example, the full recognition of tax effect on some items (e.g. common stock risk), partial recognition for some items, and no adjustment for others (e.g. certain health risks[3]).

The third approach would determine for each line (or consistent subtotal) throughout the entire RBC formula the level of tax adjustment. This would be programmed into a single adjustment at the end of the RBC summarization but prior to covariance[4]. This would

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[2] The Academy's P&C RBC Committee has also considered applying the tax adjustment after covariance.

[3] The process used to establish many of the health RBC factors appears to produce the same requirement for pre-tax and post-tax as it has been assumed that there are no other lines with profits to be offset by losses from health.
It would also be inappropriate to "gross-up" the health RBC where the final value is based on the highest dollar amount of retained risk from a specified number of claims.

[4] There would be one long formula such as [Class 1 Bonds X Tax Factor X Tax Relation] + [Class 2 Bonds X TF X TR] + etc.
The Tax Factor (TF) could be determined after December. The Tax Relationships (TRs) would allow the tax adjustment to be the full tax offset for some risk factors, half the offset for others and allow no offset for still others and would need to be determined prior to December.

allow maximum flexibility, permitting for example, a different tax adjustment based on the difference portions of Capital versus Ordinary Income risk by asset type. This approach would need to define the lines or subtotals to be used and the relation to full offset for each line used by early December. The programming for the tax adjustment could be simplified by eliminating the "Tax Relationship" option. The value of the "full" factor would not need to be decided by December and could be 0.00 if the decision were to delay changes in actual results until 2002. We are concerned that the people/time needed to complete this approach will not be available prior to December and that consistency between formulas will be much harder to maintain.

While this has not been peer-reviewed and is, therefore, not the product of the Academy of Actuaries, the members of the Academy's Joint RBC Task Force have participated in the development and editing of this memo. Many of us will be on the conference call and available to respond to questions on the effects on specific RBC formulas or more general questions.

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