



AMERICAN ACADEMY *of* ACTUARIES

**Report of the HRBC Asset Codification Work Group
To the
NAIC Health Risk-Based Capital (E) Working Group
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This report was prepared by the Academy's Asset Codification Work Group of the Task Force on Health Risk-Based Capital (HRBC).

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Introduction

The American Academy of Actuaries' Asset Codification Work Group of the Task Force on Health Risk-Based Capital was formed in August 2000 in order to respond to a request for assistance issued to the Academy by the NAIC Health Risk-Based Capital (HRBC) Working Group.

The primary purpose of this report is to present a recommended response for the Health RBC formula to those changes that were introduced to the 2001 Life RBC formula in accordance with recommendations made by the Academy's Life Risk-Based Capital Committee's Codification Subgroup. These "tax consistency" changes adopted in Life RBC had four main components:

- Deferred tax assets and liabilities were affirmed as an appropriate part of an entity's Total Adjusted Capital for Life RBC purposes;
- A new structure was developed in which "pre-tax" RBC factors are used initially and then a "tax adjustment" (the extent of which varies by item) is deducted to arrive at a "post-tax" Authorized Control Level RBC number. (We shall refer to this as a "pre-tax + tax adjustment" framework.)
- Many existing factors were recalculated in recognition of the existence of deferred taxes in statutory accounting;
- A "tax sensitivity test" was added, under which TAC is recalculated with deferred taxes excluded and ACL RBC is recalculated using pre-tax factors, for the information of regulators.

Conclusions

After considerable thought, our group has arrived at the following conclusions:

1. The deferred tax assets and liabilities calculated under SSAP 10 appear to be an appropriate part of an entity's Total Adjusted Capital for Health RBC purposes. Once sufficient data exists as to the sources of, and year-to-year variability in, health entities' deferred tax items, further research may be warranted as to whether there should be a H1 risk factor applied against the deferred tax asset.
2. With regards to the H2 factors for core health coverages (e.g., comprehensive medical, Medicare Supplement, dental, etc.), the Academy Life RBC Committee decided that there should be no tax adjustment and that the current factors should continue to be used. We agree with their decision and the rationale behind it.
3. In general, the RBC calculation for health entities, especially those with low RBC ratios, will be dominated by H2 risk. Thus, the H1 component will play a minor role in determining whether or not such an entity is subjected to RBC action levels. Consequently, it is not an appropriate use of resources for the Academy's Task Force on Health Risk-Based Capital to make independent recommendations for Health RBC on asset treatment, except for those assets specific to the health industry (e.g., health care delivery assets, health care receivables, etc.).
4. As observed in our December 2000 report, health entities are far more similar to property & casualty insurers than to life insurers with respect to both their investment philosophies and the accounting rules to which their assets are subjected. Therefore, as a general principle, we believe that common asset risk and credit risk factors should be used in the Health RBC and P&C RBC formulas, except in circumstances where there are demonstrable, industry-specific, reasons why the factors should differ.
5. While the members of our group are not experts on the P&C world, we believe it to be the case that asset risks play a somewhat larger role in the P&C RBC formula than they do in the Health RBC formula. In the light of this observation and the previous two conclusions, we believe that the Academy's Committee on Property/Casualty Risk-Based Capital should play the lead role in

determining what revisions, if any, are appropriate to the treatment of asset risks in the P&C RBC and Health RBC formulas in light of the Life RBC “tax consistency” changes.

Recommendations

As a natural consequence of the above conclusions, we are making the following recommendations for the 2002 Health RBC formula:

- A. Deferred tax items should continue to be fully included in TAC. Any further consideration of this issue, as well as any consideration of whether there should be an H1 risk factor applied against the DTA, should be suspended until 2003 (for implementation in the 2004 formula), by which time two years’ worth of data on statutory deferred tax items will be available.
- B. For the small number of asset risk and credit risk items where the P&C RBC and Health RBC factors currently differ, we recommend that our group be asked to work in concert with the Academy’s Committee on Property/Casualty Risk-Based Capital to determine whether these differences are warranted.
- C. No changes should be made to any of the H2, H3, or H4 risk factors on account of “tax consistency” issues, since it would be appropriate for the “pre-tax” and “post-tax” factors for all such items to be the same. In particular, there is no need for a “pre-tax + tax adjustment” framework for these risks.
- D. H1 risks should only move to a “pre-tax + tax adjustment” framework if and when the R1 and R2 risks in the P&C RBC formula move to such a framework. Thus, unless the P&C RBC formula was to adopt such a framework for 2002, we recommend that the Health RBC formula not adopt such a framework.
- E. Based on the above, we are not recommending any structural changes to the 2002 Health RBC formula at this time. In particular, since we are not recommending any tax adjustment items for Health RBC, there is no need to add a tax sensitivity test, as the current TAC page is sufficient to allow a regulator to calculate what an entity’s Health RBC ratio would be if deferred tax items were excluded from TAC.

In addition, once the status of health care receivables in statutory accounting is finalized, we plan on revisiting the appropriate H1 and/or H3 factors for these and other assets specific to the health insurance industry. However, we do not anticipate being able to complete this work in a meaningful and satisfactory way before the second quarter of 2002.