



AMERICAN ACADEMY *of* ACTUARIES

March 9, 2004

Anne Kelly, FCAS, MAAA
Chief Casualty Actuary
New York State Insurance Department
25 Beaver St
New York, NY 10004

Re: Review of Impact on Risk-Based Capital from Inclusion of Deferred Tax Assets & Liabilities

Dear Ms. Kelly:

The National Association of Insurance Commissioners (NAIC) has requested that the American Academy of Actuaries'¹ ("Academy") P&C Risk-Based Capital (RBC) Committee review the impact of the deferred tax assets (DTAs) and deferred tax liabilities (DTLs) on company RBC results to determine if a change to the RBC formula is warranted.

The Committee on P/C Risk-Based Capital is pleased to present this analysis of the treatment of deferred tax assets (DTAs) and deferred tax liabilities (DTLs) in the P/C Risk-Based Capital (RBC) formula.

Issue

DTAs and DTLs were included in companies' statutory financial statements, effective year-end 2001. No change nor adjustment was made to the risk-based capital formula. This affects company RBC results as follows:

- For those companies with DTAs, company surplus is higher by the amount of the admitted DTA and their Risk-Based Capital requirement is increased by the inclusion of five percent of the admitted DTA amount in the company's R3 charge.
- For those companies with DTLs, company surplus is lowered by the amount of the DTL. There is no change in these companies' Risk Based Capital requirement.

Recommendation

The P&C RBC Committee recommendation is that no action be taken at this time. This recommendation is made for the reasons discussed below.

Reasons for Recommendation:

¹ The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

1. DTLs do not appear to materially impact Risk-Based Capital results, i.e., the inclusion of DTLs does not seem to cause a company that would otherwise have been above the Company Action Level to fall below that level. Of the 295 companies recording DTLs on their 2002 financial statements, all had Total Adjusted Capital (TAC) levels in excess of their Company Action Level (CAL).
2. In a small number of instances, the exclusion of the DTA would have caused a company's TAC to fall below its CAL. We estimate about 15 companies out of almost 2,800 companies would have been affected in this manner in 2002. These fifteen companies would have been in addition to the 106 that fell below CAL using the current formula. These 15 companies have an aggregate surplus of about \$1 $\frac{3}{4}$ billion, or slightly less than $\frac{1}{2}$ of one percent of the aggregate industry surplus. The individual company surpluses range from \$2 or \$3 million (2 companies) up to about \$500 million (2 companies).
3. We do not believe it is appropriate at this time to "me-too" the RBC charge for DTA used by the Life companies since the reasons for the DTA are not comparable to the reasons for a P&C company's DTA and it is not reasonable to assume equal riskiness for the Life and P&C DTAs. Our committee is willing to review these charges now that the DTAs are separate.
4. In Conclusion # 2, the entire DTA is removed from consideration. This is equivalent to applying a 100% charge against the DTA. This is one end of the spectrum. The other end is the current practice that applies a 5% charge to the net admitted DTAs. Other alternatives might be to apply a larger charge than the current 5%, but not go as high as 100%. For example, if a charge of 15% is used instead of the current 5%, 4 additional companies fall below the CAL. This charge for DTA would be equivalent to the charge on non-affiliated common stock. If a charge of 30% is used, 5 additional companies fall below the CAL. A 30% charge is comparable to the charge for bonds and preferred stock at, or near, default.

Methodology

The effects of the DTA and DTL are currently included in the capital and surplus amount used in the RBC calculation. Prior to 2001 they were not included on the balance sheet, and were therefore not included in the calculation. This analysis consisted of performing a "what-if" scenario test on industry data from 2002 by removing the DTA and DTL from the RBC calculation.

The test began by restating a company's total adjusted capital (TAC) to exclude the net DTA and DTL. Correspondingly, an adjustment was made to each company's total RBC amount after covariance. In the current RBC formula, DTAs have a 5% Risk-Based Capital charge. Therefore, the RBC amount was adjusted by removing an amount equal to 5% of the held DTAs multiplied by 50% to approximate the covariance adjustment. This provides "what-if" RBC results for the scenario that ignores DTAs and DTLs. This approach, for companies with DTAs but no DTLs, is comparable to assuming a 100% RBC charge on the net admitted DTAs. Since we used an average covariance adjustment for all companies, this test is an approximation, not an exact re-calculation of an individual company's RBC calculation.

We then calculated the ratio of adjusted TAC to adjusted CAL. We compared each company's "Pass" or "Fail" condition to their actual condition to see if the exclusion of DTAs had an impact on the company passing or failing. We found 15 companies would have failed if their net admitted DTAs were completely excluded.

This approach was also used to determine the effects of using larger RBC charges to the DTA. Applying a 15% charge, instead of the current 5%, would have caused four additional companies to fail, and a 30% charge would have resulted in the failure of five additional companies. These results are significantly lower than the fifteen additional failures that would have occurred if credit for net admitted DTAs is totally eliminated. While it could be argued that the greater uncertainty of collecting DTAs vis-

à-vis other federal income tax recoverables would warrant a higher RBC charge, there does not seem to be much gained, at this time, by increasing the current 5% charge to 15% or 30%. Therefore, we recommend waiting to adjust the DTA charge and include its review as part of the overall review of all RBC charges.

Please feel free to contact myself or Greg Vass, Senior P/C Policy Analyst, if we can be of further assistance.

Sincerely,

Kay Cleary, FCAS, MAAA, Chairperson
Academy Committee on P/C Risk-Based Capital.