



AMERICAN ACADEMY *of* ACTUARIES

May 22, 2006

Mr. Philip Barlow, FSA, MAAA
Chairperson, Life Risk Based Capital Working Group (LRBC)
National Association of Insurance Commissioners (NAIC)
Associate Commissioner, Insurance Bureau
Dept of Insurance Securities & Banking
810 First Street NE Suite 701
Washington, DC 20002

Re: Comments concerning April 7, 2006 exposure of LRBC Instructions (LR030)

Dear Mr. Barlow:

The Life Capital Adequacy Subcommittee (LCAS) of the American Academy of Actuaries¹ is pleased to provide comments concerning the proposed 2006 Life RBC (LRBC) Instructions exposed for comment on April 7, 2006.

At its March meeting, the Life Risk Based Capital (RBC) Working Group (WG) of the NAIC received a recommendation from the LCAS concerning a company's credit to TAC (Total Adjusted Capital) for ½ of the dividend liability under coinsurance, modco, and reinsurance with funds withheld reinsurance situations. The report recommended that credit would only be allowed when the company claiming the credit had total control over the dividend decision and could realize the financial benefits associated with a reduction in the dividend scale.

In response to this recommendation, the WG requested specific examples of when the TAC credit would be appropriate for the ceding company. On a subsequent conference call, the WG voted to expose changes to the LRBC instructions necessary to accommodate the recommendations. This letter is intended to address both.

In response to the WG request for specific examples, the LCAS team working on this issue polled its membership. Only one example was cited, involving a modco

¹ The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

reinsurance agreement with an experience rated refund provision (ERR). According to paragraph 33 of SSAP 61, an ERR provides “that the reinsurer will refund an agreed upon portion of the profit to the ceding company. The reinsurance contract will provide the calculation and the factors to be included.” When this calculation includes dividends and results in positive profit, then the change in dividend scale would (1) be under the ceding company's control, (2) financially benefit the ceding company and (3) result in a surplus change to the ceding company in an amount equal to the amount of surplus that would have been generated via the dividend action in the absence of the reinsurance. Under the LCAS proposal, this company would be eligible for the dividend credit. The fact that only one example surfaced does not necessarily indicate that this is the only possible situation. In fact, the LCAS suggested an acceptable approximation of a principles-based approach partly because there is a wide variety of reinsurance arrangements and it is not possible for our small group to be aware of all of them. But given the one approach noted, the WG has several options. We see four alternatives:

1. The instructions could be left pretty much as is. The LCAS has reviewed the instructions exposed on April 7, 2006 and we find them to be generally consistent with the LCAS recommendations made at the March NAIC meeting. The one change we would offer is to clarify that the restrictions on TAC credit only apply to coinsurance, modified coinsurance, coinsurance with funds withheld, and other similar arrangements. In particular, these restrictions should not apply to YRT reinsurance. The attached Appendix 1 suggests a way to reflect this clarification.
2. The instructions could be left essentially as in the current proposal with the addition of specific language citing the ERR situation as an example. (See Appendix 2.)
3. The instructions could be modified to allow only for the specific example cited. (See Appendix 3.)
4. The instructions could be modified to allow only for the specific example cited but with additional language that would allow for other possibilities with the approval of the commissioner of the state of domicile. (See Appendix 4.)

The LCAS believes that an acceptable approximation to a principles-based individual company approach to calculating the TAC credit for the dividend liability in reinsurance situations would more properly capture the company's dividend practices in recognizing adverse events and the underlying risks, benefits and guarantees in its reinsurance contract(s). The solutions shown in Appendices 1 or 2, and, to some extent that in Appendix 4, would be consistent with this belief. The solution in Appendix 2 has been provided in response to your request.

I will be prepared to discuss our comments at the upcoming NAIC Meeting in Washington DC.

Sincerely,

/s/

Nancy E. Bennett

Chairperson, American Academy of Actuaries Life Capital Adequacy Subcommittee

Appendix 1

CALCULATION OF TOTAL ADJUSTED CAPITAL (Including Total Adjusted Capital Tax Sensitivity Test) LR030 – Alternative 1

Basis of Factors

In determining the C-1 risk factors, availability of the AVR and voluntary investment reserves to absorb specific losses was not assumed. Therefore, the AVR is counted as capital for the purposes of the formula although it represents a liability and is not usable against general contingencies. Voluntary investment reserves were eliminated from Total Adjusted Capital for the 1997 risk-based capital formula.

The Annual Statement provision for future dividends can provide a general cushion against potentially adverse future experience. As a reflection of this possible cushion, 50 percent of the Annual Statement dividend liability is included. In general, a credit to Total Adjusted Capital will not be allowed to either company when a block is reinsured under a coinsurance, modified coinsurance, coinsurance with funds withheld, or other similar arrangement. However, in situations involving experience rated refunds or other special features, an actuary would apply professional judgment to determine the appropriate amount of the Total Adjusted Capital credit. A factor of 25 percent of the dividend liability is used in sensitivity testing.

Subsidiary amounts are included as appropriate recognizing that this surplus is included within the surplus of the parent. Property and casualty subsidiaries should subtract all non-tabular discount from surplus to arrive at the adjusted surplus figure. This adjustment to surplus was phased in over a five-year period by subtracting 20 percent of the non-tabular discount the first year and an additional 20 percent each year thereafter. Beginning with the 1998 risk-based capital formula, the adjustment to surplus is 100 percent. The same adjustment is made to the surplus of a life company having ownership of a property and casualty subsidiary.

The laws of certain states allow insurers to issue a form of capital instrument called a “capital note”. A credit is allowed to Total Adjusted Capital for a capital note that satisfies all of the following conditions:

Specific Instructions for Application of the Formula

Lines (3) and (4)

When coinsurance, modified coinsurance, coinsurance with funds withheld, or any similar arrangement is involved, the amount of the dividend liability credit included in Total Adjusted Capital by the ceding company should be reduced to the extent the ceding company cannot realize the financial benefits associated with a reduction in the dividend liability. At the same time, the reinsurer should not be allowed a credit to Total Adjusted Capital for any of the dividend liability, even if the direct writer cannot take the Total Adjusted Capital credit, unless the reinsurer can demonstrate control over the dividend decision of the direct writer.

The following two questions should be considered concerning business that is reinsured under the arrangements noted above:

- Does the company have "total control" over the dividend decision?
- Does the full benefit of any future ability to change the dividend scale flow to the company?

A “no” answer to the first of these questions will eliminate the company's ability to take credit for the dividend provision related to the policies reinsured. A “no” answer

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to the second will indicate that the credit might be limited and that actuarial judgment should be used to determine the amount of the credit.

In determining the credit to Total Adjusted Capital in these reinsurance situations, the actuary should consider:

- The degree to which the block is reinsured. For example, under a typical reinsurance arrangement for a block that is 50% reinsured, 50% of the benefit of a future scale cut would go to the reinsurer. In this case, the Total Adjusted Capital credit to the ceding company should be reduced by half.
- The provisions of the reinsurance agreement regarding sharing dividend payments. For example, under a reinsurance agreement that states that the reinsurer will not share in dividend payments, the full half of the dividend liability Total Adjusted Capital credit would be allowed to the ceding company because none of the surplus impact associated with a future scale change would flow to the reinsurer.
- Any provisions for sharing costs in the agreement. For example, under an experience rated refund provision, the actuary will need to determine the extent of the effect of any future scale changes. This will involve a detailed review of the provisions of the experience rated refunds formula. The actuary typically should consider what will happen in adverse situations as this is what the RBC factors are designed to cover. The actuary should also consider the timing of the cash flows associated with the experience rated refunds formula.
- Any other relevant provisions of the agreement.

An actuarial certification is required to be filed with the RBC report when actuarial judgment is used to determine the credit to Total Adjusted Capital for a portion of the dividend liability in these reinsurance situations. The certification should be provided by a qualified actuary and should consist of at least the following:

- i. A paragraph identifying the actuary and his or her qualifications.
- ii. A scope paragraph identifying the dividend credit included and certifying to:
 - The Company's control over the dividend decision; and
 - The Company's ability to benefit from the ability to change the dividend scale in the future.
- iii. A reliance paragraph describing those areas, if any, where the certifying actuary has relied on other experts. A reliance statement from each of those relied upon should accompany the certification. The reliance statement should note the information being provided and a statement as to the accuracy, completeness or reasonableness, as applicable, of the information.
- iv. A paragraph certifying that dividend credit taken in calculating Total Adjusted Capital was determined in accordance with the principles and requirements of the NAIC RBC instructions.
- v. A paragraph disclosing all material changes in assumptions and methods from those used previously.
- vi. A paragraph stating that the qualified actuary is not opining on the adequacy of the company's surplus or its future financial condition.

When taking credit in these reinsurance situations, the actuary has the responsibility to document the basis for judgment. An actuarial memorandum should be prepared annually and available to regulators on request. As part of the support for the decision to take dividend liability credits, the actuarial memorandum should discuss the material considerations necessary to understand that decision. At a minimum, the memorandum should include the following information for each treaty for which credit is being taken:

- The block of business covered
- The type of reinsurance employed (e.g., Modco with experience rated refunds)
- Contractual/Regulatory/Other restrictions in the treaty which would limit the company's ability to realize the Total Adjusted Capital credit associated with the dividend liability to fund needs in other lines of business.
- The rationale for amount of credit taken and the analyses performed.

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Lines (5) through (7)

The source for subsidiary amounts should be reported from the subsidiaries' Annual Statements. These amounts should be adjusted by percentage of ownership before entering. All U.S. life, property and casualty and investment subsidiaries should be included.

Lines (9.1) through (9.4)

These lines calculate the credit to Total Adjusted Capital for the insurer's qualifying capital notes. The calculation on Line (9.2) limits the credit for capital notes so the total amount of capital and surplus notes included in Total Adjusted Capital is not more than one-half of Total Adjusted Capital from other sources. This is equivalent to a limit of one-third of Total Adjusted Capital from all sources, including the capital and surplus notes themselves.

Lines 11 through 15

The tax sensitivity test provides a "what if" scenario eliminating deferred tax assets and deferred tax liabilities from the calculation of Total Adjusted Capital. The sensitivity test has no effect on the risk-based capital amounts reported in the annual statement.

Line (11)

Include only the admitted portion of the deferred tax asset inside amount.

Line (13)

Line 13 should include only the admitted portion of deferred tax assets for insurance subsidiaries that are subject to RBC.

Appendix 2

CALCULATION OF TOTAL ADJUSTED CAPITAL (Including Total Adjusted Capital Tax Sensitivity Test) LR030 – Alternative 2

Basis of Factors

In determining the C-1 risk factors, availability of the AVR and voluntary investment reserves to absorb specific losses was not assumed. Therefore, the AVR is counted as capital for the purposes of the formula although it represents a liability and is not usable against general contingencies. Voluntary investment reserves were eliminated from Total Adjusted Capital for the 1997 risk-based capital formula.

The Annual Statement provision for future dividends can provide a general cushion against potentially adverse future experience. As a reflection of this possible cushion, 50 percent of the Annual Statement dividend liability is included. In general, a credit to Total Adjusted Capital will not be allowed to either company when a block is reinsured under a coinsurance, modified coinsurance, coinsurance with funds withheld, or other similar arrangement. However, in situations involving experience rated refunds or other special features, an actuary would apply professional judgment to determine the appropriate amount of the Total Adjusted Capital credit. A factor of 25 percent of the dividend liability is used in sensitivity testing.

Subsidiary amounts are included as appropriate recognizing that this surplus is included within the surplus of the parent. Property and casualty subsidiaries should subtract all non-tabular discount from surplus to arrive at the adjusted surplus figure. This adjustment to surplus was phased in over a five-year period by subtracting 20 percent of the non-tabular discount the first year and an additional 20 percent each year thereafter. Beginning with the 1998 risk-based capital formula, the adjustment to surplus is 100 percent. The same adjustment is made to the surplus of a life company having ownership of a property and casualty subsidiary.

The laws of certain states allow insurers to issue a form of capital instrument called a “capital note”. A credit is allowed to Total Adjusted Capital for a capital note that satisfies all of the following conditions:

Specific Instructions for Application of the Formula

Lines (3) and (4)

When coinsurance, modified coinsurance, coinsurance with funds withheld, or any similar arrangement is involved, the amount of the dividend liability credit included in Total Adjusted Capital by the ceding company should be reduced to the extent the ceding company cannot realize the financial benefits associated with a reduction in the dividend liability. At the same time, the reinsurer should not be allowed a credit to Total Adjusted Capital for any of the dividend liability, even if the direct writer cannot take the Total Adjusted Capital credit, unless the reinsurer can demonstrate control over the dividend decision of the direct writer.

A modco agreement including an experience rating refund provision (ERR) is an example of an arrangement that would be eligible for Total Adjusted Capital credit. When an ERR provision is involved, the full credit is allowed if the provisions of the ERR allow it to reflect any reduction in the dividend scale on a dollar-for-dollar basis and the size of the ERR is not limited to an amount less than the size of the dividend liability. If the ERR is not a dollar-for-dollar arrangement the dividend credit allowed will equal $\frac{1}{2}$ of the dividend liability times (the amount of surplus that can be realized via a 50% cut in the dividend scale)/(the amount of surplus that would have been generated via a 50% cut in the dividend scale in the absence of the reinsurance). If the amount of the ERR is limited, the size of the credit will be limited to $\frac{1}{2}$ the

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maximum size of the ERR. Credit should be reduced or eliminated to the extent that the contract is in a loss position resulting in no or a limited experience refund after taking a dividend action into account.

The following two questions should be considered concerning business that is reinsured under the arrangements noted above:

- Does the company have "total control" over the dividend decision?
- Does the full benefit of any future ability to change the dividend scale flow to the company?

A "no" answer to the first of these questions will eliminate the company's ability to take credit for the dividend provision related to the policies reinsured. A "no" answer to the second will indicate that the credit might be limited and that actuarial judgment should be used to determine the amount of the credit.

In determining the credit to Total Adjusted Capital in these reinsurance situations, the actuary should consider:

- The degree to which the block is reinsured. For example, under a typical reinsurance arrangement for a block that is 50% reinsured, 50% of the benefit of a future scale cut would go to the reinsurer. In this case, the Total Adjusted Capital credit to the ceding company should be reduced by half.
- The provisions of the reinsurance agreement regarding sharing dividend payments. For example, under a reinsurance agreement that states that the reinsurer will not share in dividend payments, the full half of the dividend liability Total Adjusted Capital credit would be allowed to the ceding company because none of the surplus impact associated with a future scale change would flow to the reinsurer.
- Any provisions for sharing costs in the agreement. For example, under an experience rated refund provision, the actuary will need to determine the extent of the effect of any future scale changes. This will involve a detailed review of the provisions of the experience rated refunds formula. The actuary typically should consider what will happen in adverse situations as this is what the RBC factors are designed to cover. The actuary should also consider the timing of the cash flows associated with the experience rated refunds formula.
- Any other relevant provisions of the agreement.

An actuarial certification is required to be filed with the RBC report when actuarial judgment is used to determine the credit to Total Adjusted Capital for a portion of the dividend liability in these reinsurance situations. The certification should be provided by a qualified actuary and should consist of at least the following:

- i. A paragraph identifying the actuary and his or her qualifications.
- ii. A scope paragraph identifying the dividend credit included and certifying to:
 - The Company's control over the dividend decision; and
 - The Company's ability to benefit from the ability to change the dividend scale in the future.
- iii. A reliance paragraph describing those areas, if any, where the certifying actuary has relied on other experts. A reliance statement from each of those relied upon should accompany the certification. The reliance statement should note the information being provided and a statement as to the accuracy, completeness or reasonableness, as applicable, of the information.
- iv. A paragraph certifying that dividend credit taken in calculating Total Adjusted Capital was determined in accordance with the principles and requirements of the NAIC RBC instructions.
- v. A paragraph disclosing all material changes in assumptions and methods from those used previously.
- vi. A paragraph stating that the qualified actuary is not opining on the adequacy of the company's surplus or its future financial condition.

When taking credit in these reinsurance situations, the actuary has the responsibility to document the basis for judgment. An actuarial memorandum should be prepared annually and available to regulators on request. As part of the support for the decision to take dividend liability credits, the actuarial memorandum should discuss the material considerations necessary to understand that decision. At a minimum, the memorandum should include the following information for each treaty for which credit is being taken:

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- The block of business covered
- The type of reinsurance employed (e.g., Modco with experience rated refunds)
- Contractual/Regulatory/Other restrictions in the treaty which would limit the company's ability to realize the Total Adjusted Capital credit associated with the dividend liability to fund needs in other lines of business.
- The rationale for amount of credit taken and the analyses performed.

Lines (5) through (7)

The source for subsidiary amounts should be reported from the subsidiaries' Annual Statements. These amounts should be adjusted by percentage of ownership before entering. All U.S. life, property and casualty and investment subsidiaries should be included.

Lines (9.1) through (9.4)

These lines calculate the credit to Total Adjusted Capital for the insurer's qualifying capital notes. The calculation on Line (9.2) limits the credit for capital notes so the total amount of capital and surplus notes included in Total Adjusted Capital is not more than one-half of Total Adjusted Capital from other sources. This is equivalent to a limit of one-third of Total Adjusted Capital from all sources, including the capital and surplus notes themselves.

Lines 11 through 15

The tax sensitivity test provides a "what if" scenario eliminating deferred tax assets and deferred tax liabilities from the calculation of Total Adjusted Capital. The sensitivity test has no effect on the risk-based capital amounts reported in the annual statement.

Line (11)

Include only the admitted portion of the deferred tax asset inside amount.

Line (13)

Line 13 should include only the admitted portion of deferred tax assets for insurance subsidiaries that are subject to RBC.

Appendix 3

CALCULATION OF TOTAL ADJUSTED CAPITAL (Including Total Adjusted Capital Tax Sensitivity Test) LR030 – Alternative 3

Basis of Factors

In determining the C-1 risk factors, availability of the AVR and voluntary investment reserves to absorb specific losses was not assumed. Therefore, the AVR is counted as capital for the purposes of the formula although it represents a liability and is not usable against general contingencies. Voluntary investment reserves were eliminated from Total Adjusted Capital for the 1997 risk-based capital formula.

The Annual Statement provision for future dividends can provide a general cushion against potentially adverse future experience. As a reflection of this possible cushion, 50 percent of the Annual Statement dividend liability is included. In general, a credit to Total Adjusted Capital will not be allowed to either company when a block is reinsured under a coinsurance, modified coinsurance, coinsurance with funds withheld, or other similar arrangement. However, in situations involving experience rated refunds, an actuary would apply professional judgment to determine the appropriate amount of the Total Adjusted Capital credit. A factor of 25 percent of the dividend liability is used in sensitivity testing.

Subsidiary amounts are included as appropriate recognizing that this surplus is included within the surplus of the parent. Property and casualty subsidiaries should subtract all non-tabular discount from surplus to arrive at the adjusted surplus figure. This adjustment to surplus was phased in over a five-year period by subtracting 20 percent of the non-tabular discount the first year and an additional 20 percent each year thereafter. Beginning with the 1998 risk-based capital formula, the adjustment to surplus is 100 percent. The same adjustment is made to the surplus of a life company having ownership of a property and casualty subsidiary.

The laws of certain states allow insurers to issue a form of capital instrument called a “capital note”. A credit is allowed to Total Adjusted Capital for a capital note that satisfies all of the following conditions:

Specific Instructions for Application of the Formula

Lines (3) and (4)

When coinsurance, modified coinsurance, coinsurance with funds withheld, or any similar arrangement is involved, the ceding company should not take the dividend liability credit unless an experience rating refund (ERR) provision is included in the reinsurance arrangement. When an ERR provision is involved, the arrangement is eligible for full credit if the provisions of the ERR allow it to reflect any reduction in the dividend scale on a dollar-for-dollar basis and the size of the ERR is not limited to an amount less than the size of the dividend liability. If the ERR is not a dollar-for-dollar arrangement the amount of the dividend credit for which the arrangement is eligible will equal $\frac{1}{2}$ of the dividend liability times (the amount of surplus that can be realized via a 50% cut in the dividend scale)/(the amount of surplus that would have been generated via a 50% cut in the dividend scale in the absence of the reinsurance). If the amount of the ERR is limited, the size of the credit will be limited to $\frac{1}{2}$ the maximum size of the ERR. Credit should be reduced or eliminated to the extent that the contract is in a loss position resulting in no or a limited experience refund after taking into account a dividend action.

At the same time, the reinsurer is not allowed a credit to Total Adjusted Capital for any of the dividend liability, even if the direct writer cannot take the Total Adjusted

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Capital credit, unless the reinsurer can demonstrate control over the dividend decision of the direct writer.

An actuarial certification is required to be filed with the RBC report when actuarial judgment is used to determine the credit to Total Adjusted Capital for a portion of the dividend liability in these reinsurance situations with ERR. The certification should be provided by a qualified actuary and should consist of at least the following:

- i. A paragraph identifying the actuary and his or her qualifications.
- ii. A scope paragraph identifying the dividend credit included.
- iii. A paragraph discussing the ceding company's control over the dividend decision and the benefit to the ceding company of a change in scale.
- iv. A paragraph discussing the experience rated refund provisions included in the reinsurance arrangements where credit is being taken, including any limitations on the size of the credit.
- v. A paragraph discussing the rationale for the credit taken
- vi. A paragraph stating that the qualified actuary is not opining on the adequacy of the company's surplus or its future financial condition.

Lines (5) through (7)

The source for subsidiary amounts should be reported from the subsidiaries' Annual Statements. These amounts should be adjusted by percentage of ownership before entering. All U.S. life, property and casualty and investment subsidiaries should be included.

Lines (9.1) through (9.4)

These lines calculate the credit to Total Adjusted Capital for the insurer's qualifying capital notes. The calculation on Line (9.2) limits the credit for capital notes so the total amount of capital and surplus notes included in Total Adjusted Capital is not more than one-half of Total Adjusted Capital from other sources. This is equivalent to a limit of one-third of Total Adjusted Capital from all sources, including the capital and surplus notes themselves.

Lines 11 through 15

The tax sensitivity test provides a "what if" scenario eliminating deferred tax assets and deferred tax liabilities from the calculation of Total Adjusted Capital. The sensitivity test has no effect on the risk-based capital amounts reported in the annual statement.

Line (11)

Include only the admitted portion of the deferred tax asset inside amount.

Line (13)

Line 13 should include only the admitted portion of deferred tax assets for insurance subsidiaries that are subject to RBC.

Appendix 4

CALCULATION OF TOTAL ADJUSTED CAPITAL (Including Total Adjusted Capital Tax Sensitivity Test) LR030 – Alternative 4

Basis of Factors

In determining the C-1 risk factors, availability of the AVR and voluntary investment reserves to absorb specific losses was not assumed. Therefore, the AVR is counted as capital for the purposes of the formula although it represents a liability and is not usable against general contingencies. Voluntary investment reserves were eliminated from Total Adjusted Capital for the 1997 risk-based capital formula.

The Annual Statement provision for future dividends can provide a general cushion against potentially adverse future experience. As a reflection of this possible cushion, 50 percent of the Annual Statement dividend liability is included. In general, a credit to Total Adjusted Capital will not be allowed to either company when a block is reinsured under a coinsurance, modified coinsurance, coinsurance with funds withheld, or other similar arrangement. However, in situations involving experience rated refunds, an actuary would apply professional judgment to determine the appropriate amount of the Total Adjusted Capital credit. A factor of 25 percent of the dividend liability is used in sensitivity testing.

Subsidiary amounts are included as appropriate recognizing that this surplus is included within the surplus of the parent. Property and casualty subsidiaries should subtract all non-tabular discount from surplus to arrive at the adjusted surplus figure. This adjustment to surplus was phased in over a five-year period by subtracting 20 percent of the non-tabular discount the first year and an additional 20 percent each year thereafter. Beginning with the 1998 risk-based capital formula, the adjustment to surplus is 100 percent. The same adjustment is made to the surplus of a life company having ownership of a property and casualty subsidiary.

The laws of certain states allow insurers to issue a form of capital instrument called a “capital note”. A credit is allowed to Total Adjusted Capital for a capital note that satisfies all of the following conditions:

Specific Instructions for Application of the Formula

Lines (3) and (4)

When coinsurance, modified coinsurance, coinsurance with funds withheld, or any similar arrangement is involved, the ceding company should not take the dividend liability credit unless an experience rating refund (ERR) provision is included in the reinsurance arrangement. When an ERR provision is involved, the arrangement is eligible for full credit if the provisions of the ERR allow it to reflect any reduction in the dividend scale on a dollar-for-dollar basis and the size of the ERR is not limited to an amount less than the size of the dividend liability. If the ERR is not a dollar-for-dollar arrangement the amount of the dividend credit for which the arrangement is eligible will equal $\frac{1}{2}$ of the dividend liability times (the amount of surplus that can be realized via a 50% cut in the dividend scale)/(the amount of surplus that would have been generated via a 50% cut in the dividend scale in the absence of the reinsurance). If the amount of the ERR is limited, the size of the credit will be limited to $\frac{1}{2}$ the maximum size of the ERR. Credit should be reduced or eliminated to the extent that the contract is in a loss position resulting in no or a limited experience refund after taking into account a dividend action.

At the same time, the reinsurer is not allowed a credit to Total Adjusted Capital for any of the dividend liability, even if the direct writer cannot take the Total Adjusted

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Capital credit, unless the reinsurer can demonstrate control over the dividend decision of the direct writer.

An actuarial certification is required to be filed with the RBC report when actuarial judgment is used to determine the credit to Total Adjusted Capital for a portion of the dividend liability in these reinsurance situations with ERR. The certification should be provided by a qualified actuary and should consist of at least the following:

- i. A paragraph identifying the actuary and his or her qualifications.
- ii. A scope paragraph identifying the dividend credit included.
- iii. A paragraph discussing the ceding company's control over the dividend decision and the benefit to the ceding company of a change in scale.
- iv. A paragraph discussing the experience rated refund provisions included in the reinsurance arrangements where credit is being taken, including any limitations on the size of the credit.
- v. A paragraph discussing the rationale for the credit taken
- vi. A paragraph stating that the qualified actuary is not opining on the adequacy of the company's surplus or its future financial condition.

Other situations involving coinsurance, modified coinsurance, coinsurance with funds withheld, or any similar arrangement may exist where credit is appropriate. Credit may be allowed in these situations with the approval of the commissioner of the company's state of domicile.

Lines (5) through (7)

The source for subsidiary amounts should be reported from the subsidiaries' Annual Statements. These amounts should be adjusted by percentage of ownership before entering. All U.S. life, property and casualty and investment subsidiaries should be included.

Lines (9.1) through (9.4)

These lines calculate the credit to Total Adjusted Capital for the insurer's qualifying capital notes. The calculation on Line (9.2) limits the credit for capital notes so the total amount of capital and surplus notes included in Total Adjusted Capital is not more than one-half of Total Adjusted Capital from other sources. This is equivalent to a limit of one-third of Total Adjusted Capital from all sources, including the capital and surplus notes themselves.

Lines 11 through 15

The tax sensitivity test provides a "what if" scenario eliminating deferred tax assets and deferred tax liabilities from the calculation of Total Adjusted Capital. The sensitivity test has no effect on the risk-based capital amounts reported in the annual statement.

Line (11)

Include only the admitted portion of the deferred tax asset inside amount.

Line (13)

Line 13 should include only the admitted portion of deferred tax assets for insurance subsidiaries that are subject to RBC.