



AMERICAN ACADEMY *of* ACTUARIES

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December 13, 2010

Mr. Lou Felice  
Chair, Capital Adequacy Task Force  
National Association of Insurance Commissioners  
2301 McGee Street, Suite 800  
Kansas City, MO 64108-2662

Re: Response to comment letters on American Academy of Actuaries' September 2010 Report -  
Deferred Tax Assets in RBC Formulas

Dear Mr. Felice:

During your October exposure of the final report of the American Academy of Actuaries  
Deferred Tax Asset Bridge Group (DTABG) five comment letters were received by you to  
which the DTABG would like to reply:

1. Dale Bruggeman (November 4, 2010) – NAIC guidance on valuation allowance – In response to this comment from Dale Bruggeman, the report (attached) has been amended to reflect that NAIC guidance directs that the adjusted Gross DTA shown as an asset (before the non-admitted reduction) should be after the valuation allowance.
2. Dale Bruggeman (November 4, 2010) – charge for intercompany receivables – In response to this comment from Dale Bruggeman, Section VIII, part A of the report has been amended to replace the reference to the NAIC recognizing the lack of risk in intercompany receivables with reference to the fact that the amount admitted as an asset is limited to balances less than 90 days old.
3. Reinsurance Association of America (RAA) (November 8, 2010) and Bell/Albrizio (November 17, 2010) – DTA amount subject to RBC charge excluding portion that is recoverable from past taxes – In response to this comment, the report has been amended to clarify that every company will get credit for the portion of the DTA recoverable from past taxes.
4. RAA (November 8, 2010) – Use of RBC model as means of measuring relative strength of insurers – Section IX. F. of our exposed report states “... the DTABG felt the RBC calculation itself, while not originally intended to be a relative measure of company strength, would be an effective means of identifying differences in the ability to realize DTAs among companies. Likewise, for this limited purpose internal to the RBC calculation, this measure will serve as the best method of assessing relative capitalization in determining a final DTA-related RBC charge for these already identified vulnerable companies. We do not suggest that RBC be used, or is useful, as a relative measure of capitalization for other purposes.” The DTABG considered other measures but decided

this was the best choice. The RAA appears to concur, stating "... we understand that the limited use of RBC as a measure of relative strength for this narrow purpose may be the best available option under the circumstances."

5. RAA (November 8, 2010) – The cut-off threshold should be no higher than 200% of Authorized Control Level RBC. In response to this comment, the DTABG states that approach would create a cliff which we did not want to present. Also, in the review of the report's first draft, the regulators stated they wanted to extend the charge higher.
6. NAIC Life Risk-Based Capital Working Group (LRBCWG) (November 8, 2010) – non-regulatory uses of RBC - The LRBCWG expressed concern with the expanded use of the RBC formula, stating that the "The LRBCWG believes the Capital Adequacy Task Force ... should focus on the regulatory purpose of RBC and leave it to those who use RBC for non-regulatory purposes to make whatever adjustments they feel are necessary to RBC formula for their use", and recommends that the DTA be removed from TAC in the calculation of RBC as that is the effect of the Academy's approach for companies with an ex-DTA RBC of 200% of Authorized Control Level or below.

The DTABG acknowledged this expansion of the use of RBC as a potential concern in Section IX, part F of our September 30<sup>th</sup> report. The DTABG, however, decided on our recommendations based on the original CADTF request to review "the continuum of risks associated with the DTA." The DTABG strongly felt that these risks will vary in large part with the capitalization of the insurer (with capitalization serving as a proxy for past and future profitability, on which realization of the DTA depends) and that the RBC charge should recognize this difference. An approach as laid out by the LRBCWG does mirror the Academy approach for weakly capitalized companies, but we do not believe it captures "the continuum of risks associated with the DTA" we were asked to review as a "one size fits all approach" does not recognize that the ability to realize the DTA will vary by company.

Additionally, the DTABG, in their deliberations, noted two particular instances where the RBC ratio is used beyond the stated regulatory thresholds as precedent for this treatment: the RBC Trend Test and SSAP10R.

Should the NAIC elect to utilize an approach similar to what the LRBCWG proposes, the DTABG would recommend revisiting our entire proposal before any changes are made. The DTABG proposal was a complete package intended to review "the continuum of risks associated with the DTA." The various factors in our proposal are interrelated; thus, we believe that a change of this magnitude to our recommendations should not be considered in isolation.

7. Bell/Albrizio (November 17, 2010) –This letter suggests the report recommends the elimination of the caps and making the RBC charge apply to the full adjusted gross DTA (i.e., a single explicit RBC charge rather than caps [an implicit charge] and an additional explicit RBC charge). In fact, the report does not make a recommendation that caps be eliminated. The report provides alternative recommendations - 1. If the caps are

maintained or 2. If the caps are eliminated (this is stated in the two bullet points at the top of page 3 and the first bullet point on page 22). However, the report does note in Section IX, part E that some members felt that it would be reasonable to eliminate the caps and have only an explicit RBC charge, but that no assessment had been made regarding the potential for other related statutory accounting issues affecting the NAIC's viewpoint on this.

8. The AHIP letter (November 17, 2010) states “The report suggests that the realization of deferred tax assets is linked to capital levels. Generally, that is incorrect”. The DTABG does not suggest there is a 100% correlation between capital levels and the realization of deferred tax assets, however, we believe that the realization of deferred tax assets is linked to capital levels in that capital levels are linked to past profitability and future profitability is often linked to past profitability. As the reports states under Section VII, part A, “... we concluded that the main risk to the value of DTAs is the inability to generate taxable income of the right character to realize the DTA. We further note that this is primarily a problem when the company is economically very weak. For the most part, stronger companies with a pattern and history of generating economic income should be able to earn sufficient taxable income over time to fully realize their DTAs.”
9. The AHIP (November 17, 2010) letter states “It is possible that entities near the Company Action Level may be financially vulnerable, if there is evidence that their capital positions may be significantly eroded in the near future. However, that has been the rationale for incorporating trend tests into the RBC formulas. The DTABG’s approach to a DTA charge where the RBC ratio is below 300% seems to call into question the validity of the existing trend tests, or at least to ignore any value they may have in identifying financially vulnerable entities.” We are not questioning the validity of the existing trend test; in fact, the report actually uses it as the basis of our recommendations and that there are other potential implications of low RBC, such as the ability to realize the DTA.
10. The AHIP (November 17, 2010) letter states “In light of the preceding points, the approach recommended by the Academy seems to suggest that entities with RBC ratios (TAC to ACL) of less than 300% are at significant risk of insolvency so that DTAs will need significantly higher RBC charges. That is completely inconsistent with the definitions of the RBC Event levels, since entities with RBC ratios in excess of 200% are above Company Action Level and no special regulatory scrutiny is considered necessary. We are concerned that the Academy’s report unfairly stigmatizes entities in this RBC ratio range.” We believe that companies with RBC below 300% are at increased risk of insolvency and that the range of 200% to 300% deserves a higher level of scrutiny as evidenced by the trend test. AHIP's concern is similar to a point raised by the RAA in their comment letter, where "a cursory comparison of property casualty companies with RBC ratios ranging from 250% to 500% shows many large, well capitalized, consistently profitable and highly rated companies with 'low' RBC ratios". The DTABG had originally recommended a 300% ratio (largely on the basis of the trend test), but decided to recommend utilizing an additional tier based on feedback received from the DTABG’s June draft report. In the September report, we recommended that companies with ex-

DTA RBCs ranging from 300-500% be subject to a more moderate charge than those below 300% (applicable even if statutory caps are retained), and that companies with ex-DTA RBCs in excess of 500% be subject to an even lower charge (or no charge whatsoever if statutory caps are retained). The DTABG understands the concerns raised regarding expansion of the use of the RBC calculation but believe strongly that the risk varies with the strength of the company. The DTABG thought the RBC calculation was essentially the least objectionable approach of the other methods we discussed (such as rating agency views, CDS pricing and bond spreads).


11. The AHIP (November 17, 2010) letter states “The Academy also draws a distinction between entities with RBC ratios above and below 500%. The distinction may be characterized as being between “average” entities with respect to the DTA being lost due to insolvency. As noted above, DTAs and solvency have only minimal connection. We are concerned about the possible inference that entities with RBC ratios below 500% are somehow “at risk at different levels” since the role of RBC is to identify potentially weakly capitalized companies and not to distinguish between average and above average capitalization levels. The premise of the Academy’s approach that the DTA risk charge should be tied to the overall potential for an entity’s insolvency should be rejected.” We believe that the risk varies by capitalization and chose 500% after receiving input from the NAIC. We acknowledge that the 500% is an arbitrary threshold, but the group thought that 500% was an appropriate level for the minimum charge and that 300% was appropriate for a significantly reduced charge (in light of the Trend Test).
  
12. The AHIP (November 17, 2010) letter states “since the real key to DTA realization is future taxable income, not current capitalization, we do not believe that the Academy’s recommendation recognizes that entities that make mostly short-term guarantees of prices and benefits can improve profitability more easily and quickly than those that make long-term guarantees and will have more difficulty in overcoming current unprofitability. If the Task Force intends to proceed along the lines laid out in the Academy’s report, we believe that some accommodation should be made regarding an issue that is particularly troubling to issuers of medical insurance and other short-tailed accident and health coverage. The recommendation fails to recognize the difference in guarantee durations, and it fails to recognize the special tax and capitalization considerations of many health insurance organizations.” The DTABG believes that many health plans cannot improve profitability faster because of rate filing requirements and short term commitments, especially in light of the new federal health reform, the Patient Protection and Affordable Care Act (PPACA). Additionally, the issue surrounding guarantee durations is not solely an issue for medical insurers. Property & Casualty insurers generally do not extend rate guarantees beyond a single twelve month policy term. They are also potentially subject to regulatory restrictions on rates that may hinder the ability to increase rates significantly enough to increase DTA realization. As such, we do not believe it is appropriate to modify the RBC charge on this basis. We believe company-specific valuation allowances are the more appropriate manner to reflect if a company is not likely to be able to realize the DTA due to long-term rate guarantees.

13. The AHIP (November 17, 2010) letter states “The proposed RBC charge, with its emphasis on the RBC ratio, may be reasonable when the organization of insurers has the ability to operate as one, as opposed to multiple insurers in many states. Health maintenance organizations, (HMOs) however, ability to choose to operate as a consolidated entity. States may require or encourage that HMOs be licensed as, and operate, as a separate legal entity in the state. This forces companies to structure their organizations to include many legal entities, all of which have their own individual capital requirements and a single tax-sharing agreement. AHIP supports the maintenance of adequate capital for each legal entity. However, in many circumstances the best placement of additional capital may not be in the legal entities but rather in the parent, which will have greater flexibility to use the capital throughout the organization, as needs arise.” The current RBC system applies at the entity level, as do the DTABG recommendations. A rationale for this is that capital being held at each entity avoids the parent organization being too thinly capitalized to protect all of its subsidiaries if there were financial issues with multiple subsidiaries at one time. Regulators appropriately want capital where they can access it in case of a potential insolvency. The DTABG believes addressing group capital issues is outside the scope of our charge and, more appropriately, should be addressed under the broader topic of group solvency regulation.

The members of the Deferred Tax Asset Bridge group members are: Barbara Gold and Robert Meilander (Life), Jim Hurley and Mark Verheyen (Property/Casualty), Donna Novak and Paula Holt (Health), and Thomas Herget (Risk Management and Financial Reporting).

Please contact Senior Risk Management and Financial Reporting Policy Analyst, Tina Getachew ([getachew@actuary.org](mailto:getachew@actuary.org)/202-223-8196) if you have any questions on our responses or need additional information.

Sincerely,



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