Report of the American Academy of Actuaries Life Risk-Based Capital Task Force on the Impact of Codification on Risk-Based Capital to the National Association of Insurance Commissioners' Life Risk-Based Capital Working Group

March 2000 - Chicago, IL

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The American Academy of Actuaries' Life Risk-Based Capital Task Force prepared this report.

Life Risk-Based Capital Task Force

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Summary

Enclosed are the recommendations of the American Academy of Actuaries Life Risk-Based Capital Task Force regarding changes needed in the RBC structure to reflect the accounting changes made by codification. These recommendations are primarily focused on the structural changes. Assuming these structural changes are approved, new RBC factors will be developed.

Subsequent refinements may also be recommended in the structure, total adjusted capital, and/or the calibration of the regulatory action levels, as it would be more efficient to make these changes to RBC at one time.

The American Academy of Actuaries' Life Risk-Based Capital Task Force would like to thank William Weller and Doug Barnert, who are members of its Codification Subcommittee, for their help in preparing this report.

LIABILITIES, CONTINGENCIES AND IMPAIRMENTS OF ASSETS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
5	A general definition of "liability" is established for the first time. A charge to operations will be recorded if (1) the loss is probable and (2) the amount is reasonably estimated.	No change is recommended.	The main impact may be that liabilities will more likely be set up for situations like lawsuits and other "C-4" type risks. This may mean that on balance TAC will be lower.

Basis/Support for Recommendation

There is no reason to change RBC since RBC is related to unforeseen future risks, whereas this SSAP relates to known specific circumstances.

Questions

None.

INCOME TAXES

SSAP #	Accounting Change Change RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
10	<u>Current</u> income tax expense is generally consistent with pre-codification. <u>Deferred</u> tax expense or credit is recognized as a component of surplus. Deferred taxes are computed on temporary differences including unrealized gains or losses and non-admitted assets (exclude AVR, IMR or Schedule F penalties). Gross deferred tax liabilities (DTL) are recognized. Gross deferred tax assets (DTA) are admitted equal to the sum of: (1) FIT paid in prior years that can be recovered through loss carry backs for temporary differences that reverse by end of subsequent calendar year. (2) Lessor of: a) amount of gross DTAs after application of above, expected to be realized within one year of balance sheet date; or b) 10% of statutory capital and surplus for prior year excluding net DTAs, EDP equipment/software and positive good will. (3) Amount of gross DTAs after application of (1) and (2) above that can be offset against existing gross DTLs.	No change to current tax expense. Change all RBC factors to appropriately reflect deferred taxes. Note the current factors reflect no tax for common stock gains (losses) and partially recognize taxes for assumed realized losses on other investments. Recognize other statutory and tax differences (such as deferred acquisition expenses or reserves) in DTA and total adjusted capital.	None for current tax expenses. Deferred tax recognition could have significant impact on changes in value of common stock - less affect on losses on bonds, mortgages, real estate, and other assets.

<u>Basis for Recommendation</u>

Recognition of deferred taxes will (1) affect total adjusted capital by the difference, if any, of DTAs and DTLs (which recognize differences in statutory and tax accounting), and will (2) affect risk based capital - either directly in each factor or indirectly as an aggregate adjustment to pre-tax RBC. In either case, the affect will be quite significant especially for common stock. All future losses, whether realized or not, will, if admitted, (see DTA rules) reduce taxes - currently only projected realized losses have been tax adjusted.

Note: This SSAP introduces other changes that may affect surplus. For example, if there is an unfavorable audit adjustment for a temporary item, such as for a reserve, the adjustment will increase the current <u>operating</u> statement tax expense. The offsetting effect or deferred tax expense will be made directly to surplus. A favorable adjustment has the opposite effect.

<u>Questions</u>

None.

DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK, FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISK, AND DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
27	Captures more off balance sheet risk of financial instruments. Disclose concentration of credit risk of financial instruments.	Augment instructions to provide face, contract amount or notional amount and nature and terms on all off-balance sheet risk reportable under FAS 105 and not reported elsewhere (e.g., in Schedule DB, question 16 of the General Interrogatories or in prior parts of Note 17). Apply the current 1% factor (or the appropriate factor for the asset class). The current RBC concentration of credit risk is more specific than SSAP 27, so no change is recommended. The disclosure on fair value does not change the statutory balance sheet so no change is recommended.	Minimal.

Note: These financial instruments, which encompass both assets and liabilities recognized and not recognized, include derivatives, financial guarantees, standby letters of credit, notes payable and other assets.

Basis/Support for Recommendation

This SSAP captures and reports more of the off balance sheet risk, if any, reportable under FAS 105. Since the data is now available, it seems reasonable to include it in the RBC calculation and likely apply the same factor.

<u>Questions</u>

FAS 105 may require the reporting of off-balance sheet risk not captured in the annual statement or RBC instructions. Should this data be captured? **Yes.** What RBC factor should apply? **Probably 1% (or the appropriate factor for the asset class).**

FAS 105 excludes long-term leases from off-balance sheet risk. Should long-term leases be dropped form the sensitivity analysis? **No.**

GUARANTY FUND AND OTHER ASSESSMENTS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
35	Establishes liability for Guaranty Fund and Other Assessments: (1) if it is probable that asset is impaired or liability has been incurred at Financial Statement Date and, (2) amount of loss can be reasonably estimated. For Guaranty Fund assessments (1) is met when insolvency has occurred.	No Change. .	Will lower TAC.

Basis for Recommendation

The impact will vary since some companies had reflected estimates of the multi-year total liabilities in varying amounts. After codification all will be required to estimate multi-year amounts so there should be more consistent results for RBC and other purposes.

Questions

None.

TROUBLED DEBT RESTRUCTURING

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
36	Defines restructuring as: "the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor it would not otherwise consider". Accounting by debtors and creditors is clarified to be, generally, fair value.	No change is recommended.	Writedowns may happen a little sooner, resulting in a decrease in TAC.

Basis/Support for Recommendation

For bonds, RBC factors are based on SVO rating, so no change is needed. For mortgages, if we were confident that the current 7.5% factor was "right" then it would make sense to consider lowering this factor since writedowns may be faster. However, there has never been a strong database for this factor and, therefore, the impetus to change this factor is likely to be modest.

Questions

1. Will the statutory financial statement continue to distinguish restructured mortgages from other mortgages? **It will.**

2. If not, should we continue to require this distinction in the RBC information? **N/A based on answer to #1.**

3. If we do have restructured mortgages separately we will need a new factor (current factor is 7.5%). **We no longer think it is necessary. The data used to determine the 7.5% initially was limited. The 7.5% is just as "right" after codification as before.**

4. Is it true that statutory financial changes plus corresponding RBC changes will remove some of the non-economic (financial statement and RBC management) incentive to restructure vs. foreclose? **It will for some companies.**

MORTGAGE LOANS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
37	Valuation allowances are established for temporary impairments. Loan origination and commitment fees are deferred and amortized over the life of the loan. Prepayment fees are recorded as investment income when received. Write-downs for permanent impairment are included in realized losses and a new cost basis is established, with subsequent recoveries not recognized.	• No changes are currently recommended. • Could change base for factor to written down value of assets in the future. • Could change restructure treatment in MEAF factor.	Impaired mortgages may be written down more quickly, resulting in a decrease in TAC (depends on current company practice).

<u>Basis/Support for Recommendation</u>

The RBC factors for "mortgages 90 days overdue, not in process of foreclosure" and "mortgages in process of foreclosure" are currently applied against the values of the assets before write-downs. Therefore the factors represent how much the "before write-down values" could change, rather than how much the current (written down) value could change. This approach was used based on the assumption that companies don't write down their mortgages consistently. Codification should bring more consistency. Assuming increased consistency, say five years after codification, we should reset the RBC factors so they apply against current (written down) values of assets.

The MEAF treatment of restructures was also reviewed - codification handles them more like a one-time event unlike the current treatment (see write-up of SSAP #36). After much discussion of this issue, we concluded there was some rationale for change, but that it wasn't necessarily compelling enough to put resources into making the change at this time.

<u>Questions</u>

1. Will the mortgage categories continue to be in the statutory financial statement (restructures, in process of foreclosure, etc.). **They will.**

2. If not, consider whether they should be added to the RBC information. **This is N/A based on answer to #1 above.**

3. Review the factors for "in process of foreclosure" and "90 days overdue, not in process of foreclosure" as a result of codification changes. **We reviewed them in light of the possibility of more consistent writedowns by companies after codification, which would allow for the more straightforward approach of applying factors to the current (written down) values rather than the values that haven't been written down (the current practice). We decided to defer proposing a change until there was evidence, say five years after codification, that write downs were treated more consistently in the industry.**

4. Review the mortgage experience adjustment factor (MEAF). Should alternative approaches to measuring quality be considered? We should attempt to remove any RBC management incentives for choosing restructures vs. foreclosure; formula should be neutral, if possible. **While there was some rationale for change, it wasn't clearly evident that we should allocate the resources necessary to execute the change at this time.**

REAL ESTATE INVESTMENTS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
40	Real estate is moved toward a GAAP-type basis, removing the categories of investment vs. foreclosed and reporting as: held for production of income, held for sale, or occupied by the company. Home office property and property held for production of income will be held at book, unless book is determined to not be recoverable. If book is not recoverable, a new cost basis is established at market. Subsequent recoveries cannot be reflected. Property held for sale will be held at lower of book or market or fair value. Current fair value is determined on a property by property basis.	We propose a new structure where the RBC factor varies by the "cash on cash return" earned on the real estate portfolio in the last twelve months. Under this structure, the higher the return, the lower the risk and therefore the factor. Two categories of properties that often have lower returns (and are perceived by many as riskier) are foreclosed properties and undeveloped land. This proposal will also lower the factors for very seasoned properties where the book value can be significantly lower than the market value, resulting in a high return. The methodology to construct the factors will be consistent with past methodology. The difference in factors between Schedule A and Schedule BA will be retained. If a structure based on "cash on cash" returns is not acceptable; our	The impact on TAC will vary by company depending on how each company interpreted the existing SAP rules. The overall impact on TAC in the industry is also uncertain, although in our informal survey it appeared TAC was on balance going down. The impact on RBC is uncertain since the factors that vary by returns have not been developed.

		second choice is to retain the investment vs. foreclosed distinction (see below).	

Basis/Support for Recommendation

The investment vs. foreclosed distinctions have been appropriately reflected in RBC, and are retained in a different structure in this recommendation. Risky foreclosed properties will likely have poor "cash on cash" returns. This recommendation also enhances RBC in several ways:

- RBC is reduced for portfolios with seasoned properties, which means low book values and high cash on cash returns.
- RBC is increased for risky properties like undeveloped land, which have poor current returns.
- RBC goes up in down real estate cycles (when incomes are down) and down in good real estate cycles -- this is a desirable feature of the recommendation.

Fortunately, the data needed for this proposal already is reported in Schedule A of the statutory statement. Unfortunately, this information is not in Schedule BA, but should be available in company records.

Questions

1. Should factors be changed? **Yes, to accommodate the new structure proposed above.**

2. Should disclosure of investment vs. foreclosed to RBC information be added? **This is no longer necessary given the new proposed structure. However, if the new proposed structure is not adopted, our second choice is to ask for disclosure of investment vs. foreclosed in the RBC filing, since it will no longer be in the statutory statement after codification. The latter would capture the risk in foreclosed properties but would not refine RBC for the risks of seasoned properties and undeveloped land.**

3. Should we strive to achieve a consistent definition of investment vs. foreclosed? **This is no longer necessary given the new proposed structure. However, if the new proposed structure were not adopted, our second choice would include developing a consistent definition. Our proposal would be that foreclosed properties cannot be reclassified to investment unless the cash on cash return on the foreclosed property is adequate to do so.**

INVESTMENTS IN SUBSIDIARY, CONTROLLED AND AFFILIATED ENTITIES

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
46	Use of market value with haircut.	Apply 22.5% to excess of statement value over book.	

<u>Basis/Support for Recommendation</u>

The haircut of market value was discussed at length separately by the RBC interested persons and regulators in 1999. They agreed to apply a RBC factor of 22.5% to the excess of statement value after the haircut over book value. This recommendation endorses the earlier agreed to action for implementation.

<u>Questions</u>

None.

JOINT VENTURES, PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
48	This is more specific on how to report limited liability companies and on the disclosures on other than temporary impairments.	No change is recommended.	

Questions

None.

INDIVIDUAL AND GROUP ACCIDENT AND HEALTH CONTRACTS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
54	Adopts current guidance with clarification of current reserving requirements for Individual and Group, Accident and Health Contracts.	None .	May reduce TAC.

<u>Basis for Recommendation</u>

No changes seem necessary since the only change is to clarify the reserve requirements so all companies (including Health Organizations) should be calculating them consistently. This could reduce some entities' TAC.

<u>Questions</u>

None.

LIABILITY FOR EXPENSES FOR CLAIMS OR LOSSES SHALL BE RECOGNIZED AS AN EXPENSE WHEN THE INSURED EVENT OCCURS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
55	The liability for unpaid claims, losses, and loss adjustment expenses has changed from using reasonable provision to best estimate; from bottom of the range (when no point is better), to the midpoint (when no point is better) which should occur rarely.	Could be very modest for taxes and midpoint but unlikely.	

Basis for Recommendation

The changes made in codification should be modest relative to the overall RBC risks being measured. Hence, no charge for these refinements is recommended.

Questions

1. Life loss adjustment expenses are often aggregated with claim reserves. Should they be reported separately? **Perhaps but see answer to #2. This recognition, however, will not change RBC since there is no factor for life claim reserves or expenses.**

2. If loss adjustment expenses are reported separately, should they have a different RBC factor? **Don't believe this refinement, if made, would have a material impact on company's RBC and may have limited theoretical basis as we are measuring expected variations in these liabilities. Loss adjustment expenses for health have been reported in both claim reserves and separately. Codification will create uniformity with separate reporting of these expenses. The effect on RBC will be that those entities that reported expenses as part of claims, will use the lower factor applied to expenses for health business expenses.**

3. Does the need to use the midpoint of an estimated range of values if no point is more likely than others require a RBC adjustment? **All other things being equal – yes. However, for most lines, health included, typically more than one model will be used so it is very unlikely to ever have results that produce "no point more likely than others" within the range developed by the actuary.**

4. Are there tax implications to the loss adjustment expenses? **Yes.**

BUSINESS COMBINATIONS AND GOOD WILL

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
68	Business combinations will be accounted for as either a statutory purchase or a statutory merger. Combinations that create a parent-subsidiary relationship shall be reported by acquiring insurer as a purchase at cost. Combinations where prospectively only one entity exists shall be accounted for as a statutory merger. Good will (positive or negative) from SCA purchases will be amortized to earnings as part of the unrealized gains or losses on these investments over the period the acquiring company benefits economically, but not more than 10 years. Good will (positive or negative) resulting from assumption reinsurance is amortized to operations as a component of general insurance expenses over same period as defined for SCA purchases. Positive good will is limited to 10% of parent's capital and surplus excluding any net positive good will, net deferred tax assets and EDP equipment and software. Any impairment, other than temporary, for a purchase must be written down to fair value and accounted for as a realized loss. The new cost basis is not changed for subsequent recoveries in fair value.	Apply same factor to admitted portion of good will as is applied to investments in subsidiary, controlled, and affiliated entities (SCA entities) - i.e. 22.5% to both insurance and non-insurance SCA entities.	Current reporting of goodwill is not consistent so the effect on RBC is not easily determined.

Basis for Recommendation

Since the risk is that of the good will of subsidiary, controlled, and affiliated entities (SCA entities), and the factor applied to SCA entities is consistent for all three RBC formulas, it seems reasonable to also use the same factor for good will. The limits on the admitted portion of goodwill and its rapid amortization will be somewhat comparable to the "haircut" applied to SCA entities market values.

Alternatives for the NAIC to Consider

The common stock factor could be used since this is the same as the value of goodwill related to non-insurance SCA entities that is "pushed down." However, this increases the number of situations where the formulas differ even though the statutory asset value is not different.

The factor (22.5%) could be applied to the total goodwill before limitation and the RBC value reduced by all or a substantial portion of the reduction from full value to admitted value. In general, the RBC formulas do not recognize the potential for non-admitted assets to reduce the effects of variability on the admitted portion. In this situation there is potential for the non-admitted portion to have a substantial effect on variability. Rules for allocating admitted and non-admitted goodwill between insurance and non-insurance SCA entities would need to be developed.

HEALTH CARE DELIVERY ASSET LIMITATIONS

SSAP #	Accounting Change Affecting RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
73	Health Care Delivery Assets (HCDA) are in real estate a non-liquid asset and other health service-based assets – e.g., hospital beds. They are to be recognized under codification as admitted assets without limitation.	Varying factor that increases as the HCDA increases as a percentage of all assets, such as 10% to 30%. Use real estate factor for those with modest percentages such as 20% or less.	

<u>Basis for Recommendation</u>

The risk of asset value realization for these assets increases as the HCDAs increase to a significant portion of all assets since they then become, by definition, an important source of any cash needs. The factor may grade up from 10% for real estate to the maximum for equities of 30%.

Referred to HORBC for final recommendation at December NAIC meeting.

POSSIBLE AFFECT ON TOTAL ADJUSTED CAPITAL FOR SOME COMPANIES

SSAP 16 -- ELECTRONIC DATA PROCESSING EQUIPMENT AND SOFTWARE

SSAP 42 -- SALE OF PREMIUM RECEIVABLES