AMERICAN ACADEMY of ACTUARIES

September 30, 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: American Academy of Actuaries' Final Report - Deferred tax assets in RBC formulas

Dear Mr. Felice:

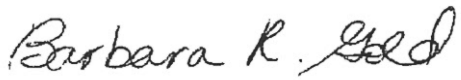
On December 17, 2009, the Capital Adequacy Task Force asked the American Academy of Actuaries[1] to review the risks associated with deferred tax assets (DTA) in all three RBC formulas, evaluate the need for a risk charge for the Life and Health DTA. and review the basis for the existing P&C DTA. The Academy has now completed its final report, and it is attached to this letter.

The members of the Deferred Tax Asset Bridge group 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/202-223-8196) if you have any questions on our comments or need additional information.

[1] The American Academy of Actuaries ("Academy") is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States

Sincerely,



Barbara R. Gold, FSA, MAAA
Co-Chair, Deferred Tax Asset Work Group
American Academy of Actuaries

Robert Meilander, FSA, MAAA
Co-Chair, Deferred Tax Asset Work Group
American Academy of Actuaries

Alexander Krutov, ASA, MAAA, FCAS, CERA
Chair, Property/Casualty RBC Committee
American Academy of Actuaries

Donna Novak, ASA, MAAA, FCA
Chair, Health Solvency Work Group
American Academy of Actuaries

R. Thomas Herget, FSA, MAAA, CERA
Chair, Risk Management & Solvency Committee
American Academy of Actuaries

Deferred Tax Asset Bridge Group Report
September 2010

TABLE OF CONTENTS

Deferred Tax Asset Bridge Group Report
September 2010

I. Executive Summary

At the request of the Capital Adequacy Task Force of the National Association of Insurance Commissioners, the American Academy of Actuaries (Academy) undertook a project to consider the appropriate treatment of the Deferred Tax Asset (DTA) in the Risk-Based Capital (RBC) formulas for Life, Property / Casualty (P&C), and Health and formed the Deferred Tax Asset Bridge Group (DTABG) to complete this work. In accordance with the NAIC's request, the DTABG also considered the situation both with and without regard to admissibility as an asset under statutory accounting.

The DTABG has completed its analysis and has concluded:

- The primary risk to realizing the DTA is inability to earn the needed taxable income to realize the DTA;
- This risk is a function of company viability (financial strength);
- the risk associated with that portion of the DTA supported by previous taxes paid is de minimus;
- Current statutory accounting rules recognize this risk by adjusting or capping the amount of DTA admitted as an asset:
    - Valuation Allowance – reduces gross DTA to the amount "more likely than not" to be realized
    - Realizability Limitation – limits admitted DTA to the expected amount to be realized within one year (temporarily increased to within three years through 12/31/2010 for companies with sufficient capital)
    - Surplus Limitation – limits admitted DTA in excess of that recoverable from past taxes to 10% of surplus (with some adjustments) (temporarily increased to 15% through 12/31/2010 for companies with sufficient capital)
    - Deferred Tax Liabilities (DTLs) – to the extent not admitted through the above rules, DTAs can be admitted to the extent they can offset DTLs
- These realizability and surplus limitations operate as implicit 'RBC charges' and increase volatility in statutory surplus relative to what would be observed if caps were not applied.

Given these conclusions, the DTABG recommends the NAIC consider the following approach to the RBC charge for the DTA:

- The RBC charge should reflect the company's level of capitalization, as measured by the RBC ratio calculated without the Admitted DTA in Adjusted Capital (with certain other adjustments) (Ex DTA RBC);
- The RBC charge should be placed in a portion of the RBC formula that is outside the covariance adjustment (C-0 for life, R-0 for P&C, and H-0 for health). It is important to note that by placing the RBC charge outside of the covariance adjustment it has a greater impact on the RBC result than if it were subject to the covariance adjustment;
- The amount of the RBC charge should eliminate the benefit of DTAs in calculating an RBC ratio for companies with an Ex-DTA RBC ratio less than 200% of ACL and should be floored at 0% or 1%, depending on the admissibility limits placed on the DTA, of the amount of DTA not supported by past taxes paid for companies with an Ex DTA RBC Ratio over 500%:

- If the full DTA less any valuation allowance (adjusted gross DTA) is admitted, the floor should be 1%.
- If current (or similar) capping procedures are maintained, the floor should be 0% given the resulting implicit 'RBC charge' of the capping procedures.

The DTABG recognizes that its recommendations may spur debate within the NAIC and among various interested parties. More specifically, two principal concerns have been identified:

1. The primary purpose of the RBC model has been to identify weakly capitalized and at-risk companies and not to measure relative company strength among the companies. This proposal could be viewed as potentially expanding the role of the model beyond the original stated intent.
2. Increasing the charge as a company's capitalization deteriorates will accelerate declines in a company's RBC ratio.

These are reasonable issues to raise and have been discussed by the DTABG. The DTABG concluded, after considering these issues, that the approach proposed in this document is reasonable given the unique nature of the DTA.

This document presents an overview of the issues, steps taken in reviewing the issues, recommendations and the rationale behind the recommendations.

II. Introduction

A. Summary of Issue

On December 7, 2009, at the NAIC Executive / Plenary meeting in San Francisco, the NAIC adopted a temporary accounting change which affects how insurance companies recognize deferred tax assets.

Accompanying the adoption of the temporary provision, a 5% post-tax post-covariance RBC charge was applied to the incremental DTA amount for Life companies. For P&C companies, the existing 5% pre-covariance DTA risk charge, applicable to the entire admitted DTA amount, was retained. Post-covariance, this becomes less than 1%.[1] For Health Insurance companies, currently there is no RBC charge associated with the DTA.

For a more thorough analysis of the risks associated with DTAs, the NAIC's Capital Adequacy Task Force (CADTF) made the following request of the Academy:

> The American Academy of Actuaries (Academy) will review the risks associated with deferred tax assets (DTA) in all three RBC formulas, evaluate the need for a risk charge for the Life and Health DTA and review the basis for the existing P&C DTA charge. The Academy will also determine the appropriate placement of the charge in each RBC

[1] The December 17, 2009 Meeting Summary Report of the Capital Adequacy Task Force references an analysis which concluded that the P&C RBC charge of 5% within covariance is equivalent to a 0.6% effective charge outside of covariance for the P&C industry at year-end 2008.

formula. The review should encompass the continuum of risks associated with the DTA as defined by Statutory Accounting Principles, before and after any statutory adjustments to the admitted value of the DTA. Included in this continuum of risks is consideration of the impact of tax allocation agreements on the DTA amounts held at insurance entities.

A preliminary report of the review is due June 1 and the target completion date is September 15, 2010. The results of the Academy review will be considered for implementation in the RBC formulas for year end 2011 or later; the review will not address the temporary change to statutory DTA for 2009 and 2010 contained in SSAP 10R.

B. Project History

DTAs and DTLs were added to the statutory balance sheet as a part of the codification of statutory accounting that was implemented on January 1, 2001. Prior to that time deferred tax amounts did not exist in statutory accounting (although they did exist in Generally Accepted Accounting Principles (GAAP) accounting). As described later, inclusion of deferred income taxes is necessary to properly reflect the after-tax impact of economic events for which the tax accounting and statutory accounting differ.

When DTAs were added as part of statutory accounting, the amount that could be admitted in the statutory statement was limited. The limits put in place at that time were a function of a combination of past taxes paid, when differences between statutory accounting and tax accounting reversed, the company's surplus, and the company's deferred tax liabilities. More specifically, codification allowed for gross DTAs to be admitted in an amount equal to the sum of:

1. Federal income taxes paid in prior years that can be recovered through loss carry backs for existing temporary differences that reverse by the end of the subsequent calendar year;
2. The lesser of:
    i. The amount of gross DTAs, after the application of paragraph 1, expected to be realized within **one year** of the balance sheet date; or
    ii. **Ten percent** of statutory capital and surplus in the most recently filed statement, adjusted to eliminate the DTA, EDP equipment and operating systems software and any net positive goodwill; and
3. The amount of gross DTAs, after application of paragraphs 1 and 2 that can be offset against existing gross DTLs.

When DTAs were first included as statutorily admitted assets, their presence was reflected in the RBC amount for P&C companies but not for life and health companies. In the P&C formula, a charge of 5% was attached to the DTA in the R3 (credit risk) part of the formula. This charge is reduced through the working of the covariance adjustment to less than 1% for the P&C industry in the aggregate. There was no comparable charge in the life and health RBC formula for the DTA. At the time DTAs were implemented, it was the opinion of various life RBC groups that an RBC charge was not necessary given the conservatism provided by the DTA limits.

It is our understanding that discussions on expanding the admissibility of DTAs in statutory accounting began in November 2008. At that time, the NAIC declined to adopt expanded admissibility of the DTA on an accelerated basis, wanting to spend more time, during 2009, thoroughly analyzing the issues and their impacts on statutory financials. However, some states allowed such greater recognition of the DTA through a permitted practice in 2008, creating diverging practices in the industry.

On December 7, 2009 a temporary accounting change, a revision of Statement of Statutory Accounting Principles (SSAP) Number 10, was adopted by the NAIC. SSAP 10R permits eligible companies[2] to elect to replace the '1 year and 10%' rule with a '3 years and 15%' rule, with an effective date of 12/31/2009 and a sunset after 12/31/2010. The temporary nature of the accounting change reflected the NAIC's desire to further study DTA accounting. In addition, the new SSAP makes explicit a "more likely than not" test in determining "adjusted" gross DTA. Since the adoption of the new limits, companies can admit adjusted gross DTAs in an amount equal to the sum of:

1. Federal income taxes paid in prior years that can be recovered through loss carry backs for existing temporary differences that reverse by the end of the corresponding IRS carry back period (life companies, 3 years; all others, 2 years);
2. The lesser of:
    a. The amount of adjusted gross DTAs, after the application of paragraph 1, expected to be realized within **three years** of the balance sheet date; or
    b. **Fifteen percent** of statutory capital and surplus in the most recently filed statement, adjusted to eliminate the DTA, EDP equipment and operating systems software and any net positive goodwill; and
3. The amount of adjusted gross DTAs, after application of paragraphs 1 and 2, which can be offset against existing gross DTLs.

As part of the temporary change, regulators included the establishment of a DTA risk charge for life companies to be incorporated in the life RBC formula so that the underlying risks of the non-recoverability of the DTA would be taken into consideration in the RBC formula development. The CADTF recommended that a charge of 1% of the additional DTA amount be established within C-0. The 1% charge was conservative but in line with the effective P&C charge. The life formula's placement in C-0 meant that it would not be affected by the covariance adjustment.

During a CADTF call to consider adoption of the initial proposal for the life formula, after considering various alternative charge levels, CADTF approved a 5% charge against the excess of the new DTA amount over the old DTA amount, placed in C-0.

As the work of the DTABG progressed, it was concluded that a reasonable and practical approach to establishing charges need not vary by product type (life, casualty and health insurance), as many of the considerations are the same for all product types and the accounting is similar. This led to a single recommended approach. This approach has been thoroughly

[2] At the time these changes were made the NAIC also established "guardrails" that provide that if a company's RBC ratio without the additional admitted DTA is less than 250% of Authorized Control Level (ACL) for life companies and 300% for P&C companies, the company can't admit the additional amount.

reviewed by the following Academy groups: the Life Capital Adequacy Subcommittee, the P&C RBC Committee, the Health Solvency Task Force, and the DTABG.[3]

III. Reasons for Deferred Income Taxes

DTAs and DTLs arise because tax accounting and statutory accounting rules differ in their recognition and measurement standards. Reflecting deferred taxes on the balance sheet is a means of accounting for future taxable income/expense whose incidence is expected to differ from future statutory income/expense and is a means of assuring appropriate comparisons between companies.

The recognition of DTAs and DTLs results in a matching of the tax amounts with the statutory income (loss) that gave rise to them. If DTAs or DTLs were not recognized then a company's statutory balance sheet would not appropriately reflect all assets and/or liabilities as a result of the statutory income (loss) generated.

This can be shown by a hypothetical example. Consider a 1-year policy, issued in the middle of calendar year 1. While many other factors, such as premiums and expenses, would affect the income statement, this example will focus on the impact of reserves and taxes.

Balance Sheet Liabilities for December 31

	Year 1	Year 2
Statutory reserve	$100.00	0
Tax reserve	90.00	0

This balance sheet example causes a reserve build up and runoff resulting in $100 of statutory loss in year 1 and $100 income in year 2. However, the comparable amounts in the tax return are only $90. The $10 difference is referred to as a "temporary difference."

At a 35% marginal tax rate, the $10 temporary difference would result in a $3.50 DTA established at the end of year 1. Establishing a DTA will result in the following income with respect to the reserve:

	Year 1	Year 2
(1) Statutory Income/(deduction)	$(100.00)	$100.00
(2) Taxable Income/(deduction)	(90.00)	90.00
(3) Tax (at 35% of 90.00)	(31.50)	31.50
(4) DTA increase/(decrease)	3.50	(3.50)
(5) Total Tax Expense [(3)-(4)]	(35.00)	35.00
(6) Effective Tax Rate [(5)/(1)] on reserves	35%	35%

As shown, this adjustment to tax expense is needed to make the effective tax rate equal to the marginal tax rate. If this adjustment is not made, then there is a distortion with respect to the statutory income statement as well as to economic tax expense. Thus, comparisons of balance sheets between companies would not be valid.

[3] The DTABG acknowledges tax accounting guidance provided by Marty Chotiner, Vice President, Prudential.

DTAs and DTLs can arise from many different sources. The DTABG reviewed a sampling of Note 9C disclosures for P&C companies; it indicates that the major sources of DTAs tend to fall into a few principal categories.[4] We were not able to do such a review of the Life Annual Statements. However, SMART Business Advisory, LLC performed a survey on year end 2008 statutory deferred taxes, receiving close to 50 responses, and they shared the principal categories with us. Based on these two analyses, it appears that the principal categories of DTAs are:

- Reserves and associated premium-related items, such as loss reserve discounting and unearned premium reserves
- Tax Deferred Acquisition Cost (DAC) balances
- Tax related items, such as carry forwards (capital and operating) and foreign tax credits
- Investment related items, such as unrealized losses; non-admitted assets; affiliate investments and impaired investment write downs
- Employment benefit related liabilities
- Policyholder dividends
- Other liabilities, such as litigation reserves

IV. Description of Calculation of Deferred Income Taxes

The calculation of DTAs and DTLs is defined in paragraphs 5 through 7 of SSAP 10. Additional guidance is also provided in questions 2, 3 and 8 of the implementation questions and answers.

In general, DTAs and DTLs are created based on differences between the tax basis and statutory basis of assets and liabilities that will result in taxable or deductible amounts in some future year(s). The four most common differences between statutory and tax treatment are:

a) Revenues or gains that are taxable after they are recognized in statutory income.
b) Expenses or losses that are deductible after they are recognized in statutory income.
c) Revenues or gains that are taxable before they are recognized in statutory income.
d) Expense or losses that are deductible before they are recognized in statutory income.

Temporary differences in income or expense recognition typically create differences in the basis of the corresponding asset or liability. Temporary differences include unrealized capital gains and losses and non-admitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), and Schedule F penalties.

[4] Note 9C category definitions and disclosures are not standardized, so disclosures vary by company. Additionally, within the NAIC's database, the Notes to the Annual Statement are not captured as numeric fields, making a detailed review of the individual components impractical at this time.

DTAs and DTLs are determined by multiplying the temporary differences by the enacted[5] tax rate. Tax laws may apply different tax rates to ordinary income and capital gains. At the Federal level, these rates have been the same for many years.

DTLs are not recognized for income that is permanently reinvested in a foreign country because this is not viewed as becoming taxable in some future year. DTAs are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the gross DTAs will not be realized. The DTA after valuation allowance is referred to as the "adjusted gross DTA."

When we refer to the DTA in our recommendations, we are referring to the adjusted gross DTA unless otherwise specified. It is the adjusted gross DTA that is subject to the admissibility limits.

V. Admissibility of Deferred Income Tax Assets (DTA)

Once the DTAs and DTLs have been determined, SSAP 10R requires calculations in paragraphs 10 and 11 to determine the portion of such DTAs that will be admitted. Additional guidance is also provided in questions 4, 5a, 5b, 6, 7, 8, 11 and 13 of the implementation questions and answers.

In general, adjusted DTAs are admitted to the extent of:

1. federal income taxes paid in prior years that can be recovered through loss carry backs for existing temporary differences that reverse within three years[6] plus
2. the portion of the remaining adjusted DTA expected to be realized in the subsequent three years subject to a limit of 15% of Statutory surplus as adjusted[7] plus
3. the amount of DTAs that can offset DTLs, to the extent not already admitted in 1 and 2 above.

Items 2 and 3 are determined on a standalone legal entity basis.

See Appendix 1 for an example illustrating the admissibility test of paragraph 10.

The term "taxes paid" means the total tax (both regular and alternative minimum tax (AMT)) that was or will be reported on the reporting entity's federal income tax returns for the periods included in the carry back period including any amounts related to contingent taxes. Taxes paid should reflect the impact of any amended return or settlement with the IRS as well as the impact of any Tax Sharing Agreement.

The particular year in which temporary differences reverse, resulting in taxable or deductible amounts, generally is determined by the timing of the recovery of the related asset or settlement

[5] Q&A 3.2 states the following: "(The) SSAP … requires that deferred tax assets and liabilities be measured using the enacted tax rate that is expected to apply to taxable income in the periods in which the DTA or DTL is expected to be settled or realized.

[6] Subject to the limits of SSAP 10R. SSAP 10R increased the reversal of temporary differences period from 1 year to the time period consistent with IRS carry back provisions, not to exceed 3 years for 2009 and 2010.

[7] Subject to the limits of SSAP 10R. SSAP 10R increased the subsequent years to consider from 1 to 3 years and increased the limit from 10 to 15% of surplus for 2009 and 2010.

of the related liability. When scheduling the reversal of temporary differences, the method employed needs to be systematic, logical and consistently applied.

Differences between statutory and tax accounting which are projected to originate in the future and their subsequent reversals, are considered in assessing the existence of future taxable income. However, they should not impact the scheduling of existing temporary difference reversals.

In determining the amount of taxes that can be recovered through loss carry backs, the amount and character (i.e., ordinary versus capital) of the loss carry back should be considered. The impact of the AMT should also be considered. For companies that are part of a consolidated income tax return, "taxes paid" means the amount paid or expected to be paid to the parent and the amount of carry back that may be considered is the amount that the company can reasonably expect to have refunded by its parent. The amount reasonably expected to be refunded by its parent is limited to the amount paid by the company.

In determining the amount of DTAs that can offset DTLs, the character (i.e., ordinary versus capital) of the DTAs and DTLs must be taken into consideration. A gross DTA related to unrealized capital losses cannot be offset against an ordinary income DTL. However, a DTA associated with an ordinary loss can be offset against a DTL associated with an unrealized capital gain.

VI. Impact of Statutory Caps on DTA

The DTABG believes it is important when assessing the risks associated with the DTA to understand the ramifications of the accounting conventions affecting the amount of the DTA that can be admitted.

Current statutory accounting guidance (SSAP10 or SSAP10R, as applicable) provides for a valuation allowance that adjusts the amount of gross DTA downward and further limits the admissibility of the adjusted gross DTA to a capped percentage of surplus (10%, with a temporary cap of 15% permissible under SSAP10R for companies with qualifying RBC ratios), as well as a finite period of expected realization (limited to DTAs expected to be realized within one year, with a longer period of 3 years allowed under SSAP10R for companies with qualifying RBC ratios).

It is important to note that DTAs are reduced by a valuation allowance if, based on the available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the gross DTAs will not be realized. Note that the amount of total DTA that is available in the annual statement blank is before the valuation allowance. The amount of the valuation allowance is included in the non-admitted DTA. As a result, we are not able to estimate how much the valuation allowance contributes to the non-admitted DTA.

The caps provided in SSAP 10 and SSAP 10R provide conservatism. These caps serve to limit the amount of DTA a company can count as an admitted asset. The remainder of the DTA is referred to as the non-admitted DTA. The portion of the total DTA that is non-admitted is typically substantial. In 2009, the first year that the expanded limits were fully available, 59% of

the total DTA within the life industry was non-admitted. The comparable number for P/C companies was 49%; for health insurers, 74%. In 2007, the last year when the new limits were not available to any company, the non-admitted portion for the life industry was almost 70%. The comparable number for P/C companies was 57%; for health insurers, 78% (see Appendices 3 through 5).

From a risk to capital and liquidity perspective, capping the admitted portion of the DTA as currently codified essentially serves the same function as would a capital charge in the RBC calculation. While a capital charge in the RBC calculation increases the Authorized Control Level (ACL) Risk-Based Capital (the denominator in the RBC calculation), the capping of admissibility reduces the Adjusted Capital (the numerator in the RBC calculation). Either approach serves to reduce the RBC ratio for companies with DTAs.

By looking at the aggregate industry numbers as of December 31, 2009, we can estimate the RBC charge that would be required to duplicate the effect of the current cap as shown in Appendix 2. For the life insurance industry, the RBC charge that would be required to duplicate the effect of the current cap is about 14%, outside of any covariance.[8] However, when the RBC ratio is higher, it takes more capital to cover a smaller amount of RBC, making the implied charge lower. If the Life RBC ratio was 200% of ACL, for example, the equivalent charge is around 50%. For the P&C industry, the RBC charge that would be required to duplicate the effect of the current cap is about 13%, outside of any covariance. For the health insurance industry, the RBC charge that would be required to duplicate the effect of the current cap is about 24%, outside of any covariance.

The presence of the surplus caps also creates volatility in statutory surplus for companies that have DTAs in excess of the surplus cap. This volatility is not due to any risk to the insurer, but rather it is due to the application of statutory accounting rules. Thus, we do not think it appropriate to include consideration of this volatility in developing an RBC charge.

The following hypothetical example illustrates the impact of capping by assuming a static balance sheet with the exception of unrealized gains and losses. Consider what happens with unrealized losses on an investment. These represent a source of DTAs for insurance companies as the tax rules do not recognize the loss until realized either through a sale or if the security is determined to be worthless. On the other hand, statutory accounting recognizes the impact on surplus of the decline in value without such events occurring.

[8] Note that this is understated as we did not have the ability to remove the current RBC charge for the admitted DTA from the data with respect to the Authorized Control Level capital requirement available to us.

		12/31/2010	
	12/31/2009	With Capping	Without Capping
Assets			
Invested Assets	1,000	980	980
DTA	20	27	27
Admitted	20	18 *	27
Non-Admitted	-	9	-
Total Admitted Assets	1,020	998	1,007
Liabilities			
Policyholder Reserves	800	800	800
Surplus Ex DTA	200	180	180
Surplus	220	198	207
Change in Surplus During 2010		(22)	(13)
Change in Unrealized During 2010		(20)	(20)

* The cap is based on surplus as of the prior statement period. For simplicity we have shown the results as though the unrealized loss occurred in an interim period, such as 9/30/2010

In the example, the opening balance sheet at 12/31/2009 has invested assets of $1,000, loss reserves of $800, a DTA of $20, and surplus of $220. For the purposes of this example, we are assuming a 10% cap on the admissibility of the DTA. As the cap is based on surplus excluding the DTA, the effective cap would be $20, which is the value of the total DTA. As such, at 12/31/09 there is no impact of capping.

We then assume that the only change during 2010 is a loss of $20 flowing through surplus. The total DTA then increases to 27 (the opening position of $20 plus 35% of the $20 unrealized loss), assuming there are no character issues (capital or ordinary) with respect to the DTA.

The balance sheet at 12/31/10, assuming a 10% cap on DTA would show an admitted DTA of $18 (10% of $180, the surplus excluding the DTA[9]), with the remaining $9 of DTA being non-admitted.

Under this scenario, statutory surplus decreases by $22, 10% more than the actual pre-tax change in unrealized losses. If the DTA were uncapped and the full $27 admitted, statutory surplus would drop by $13 (the $20 change in unrealized losses adjusted for a 35% tax rate). Because of the capping, the volatility in surplus is magnified.

An additional result of the current statutory caps is that the capping impacts companies differently depending on the characteristics of the business they write. This occurs because temporary differences between statutory and tax earnings vary by product. In general, this difference is greater for long tailed liabilities than for short tailed liabilities.

[9] The statutory cap on the DTA applies to the surplus as of the prior reporting period. To simplify this example, we have applied the cap based on surplus as of year-end 2010. If the unrealized loss had occurred during Q3 2010, reducing surplus as of 9/30/2010, year-end surplus and DTA capping would appear as noted in this example.

Because DTAs arising from these temporary differences use up a portion of the statutory cap, those companies with the greatest amount of temporary differences will have the smallest amount of remaining cap after consideration of reserves. As a result, these companies are, in effect, penalized relative to companies less impacted by temporary differences.

When this effect is combined with the volatility introduced by the statutory caps, those companies writing lines that generate greater DTAs may see increased surplus volatility. Once again, this volatility is introduced not due to the risk to the insurer, but rather due to the accounting rules. Thus, we do not think it would be appropriate to include consideration of this volatility in developing an RBC charge.

VII. Risk Analysis

Risk-Based Capital captures asset risks based on factors developed for various asset types. As such, an analysis of whether admitted DTAs, as an asset, should have risk factors assigned is appropriate. Risk factors for assets are based on such concepts as historical probability of loss and volatility. The DTA is not volatile in isolation; the volatility of the DTA is a function of the volatility of the underlying assets and liabilities.

A. Risks associated with DTAs

The DTABG examined a number of different risks to DTAs but found that all of those risks can be summarized by the following three categories:

1. Inability to generate taxable income of the right character to realize the DTA;
2. Extension risk, i.e., the inability to generate taxable income soon enough to realize the DTA; and
3. The risks that federal legislative or regulatory tax changes could impact the value of the DTAs before they are realized.

We believe that the first of these risks is the only one of major significance. While extension risk is a consideration, the period of time allowable for taking tax benefits related to DTAs is quite long (up to 15 years for ordinary loss carry forwards for life insurers; up to 20 years for ordinary loss carry forwards for non life insurers and 5 years for capital loss carry forwards for both). In addition, the valuation allowance will adjust the gross DTA to reflect any concerns with the ability to realize DTAs within these periods. As a result, we believe that a healthy company operating as a going concern ought to be able to generate enough taxable income over those time periods to realize its adjusted gross DTAs.

There are federal legislative and regulatory tax changes that could impact the value of the DTAs before they are realized. For example, federal tax rates may change or the calculation of the tax base could be changed. However, federal marginal corporate tax rates have changed only once since 1986, from 34% to 35%, in 1993. If tax rates decrease, then the value of the DTA will decrease, all else equal. Conversely, if tax rates increase, then the value of the DTA will increase. Further, accounting guidance requires tax rate changes to be incorporated into financial accounting on enactment date, not the effective date, thus providing users of the financials adequate time to understand the impact. At the current time, it seems that if corporate rates were reduced, such a reduction would likely be accompanied by a broadening of the tax base;

therefore, the impact on the DTA would depend on the base-broadening measures that were enacted. These are risks that should be considered in determining any RBC charge, but, given historical and current circumstances, the likelihood of not realizing the DTA due to lower tax rates seems low.

As a result, 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. It is much less clear how much value the DTA has for weaker companies; it is possible the DTAs may have value to a successor company.

The materiality of the risks to the DTA will be a function of the extent to which statutory rules allow for their admission. We note that the current constraints on admissibility severely limit the risks. In particular, the more-likely-than-not requirement underlying the valuation allowance reduces the risk associated with realizing the admitted DTA. Additionally, the 1 and 3 year limits on turnarounds further reduce this uncertainty. The 10% and 15% of surplus limitations will often reduce admitted DTAs below a threshold where risk to realizability is material. Statutory "guardrails" that limit the use of DTAs in certain situations further reduce the risk.

While we acknowledge that the principal risk associated with DTA is the inability to generate taxable income of the right character to realize the DTA, it should be noted that some of the DTA is supported by taxes already paid. The company can take future losses against past taxes paid, even in the absence of current taxable income. As a result, we believe the risk associated with DTAs backed by taxes already paid is de minimus.

For the remaining DTAs, the principal risk is the ability to generate taxable income. For insurers, the ability to earn sufficient taxable income in the future is highly correlated to their ability to continue to operate in the future. As such, the risk to realization is inherently greater for weaker companies than it is for stronger companies.[10]

With respect to weaker companies and their ability to monetize the DTA in a sale of the company, there are numerous guidelines and limitations in the Internal Revenue Tax Code related to certain DTAs. These limitations vary depending on the type of DTA (e.g., deduction, credit, net operating loss) and the structure and terms of the transaction. That said, those limitations (some of which are a function of the purchase price) will generally be more strict for transactions involving distressed entities than they would be for healthy entities. This further justifies the DTABG's view that any Risk-Based Capital charge applied to the DTA should take into account the relative strength or weakness of the reporting company.

The level of capitalization of a company can be measured using some form of RBC ratio. In this case, an RBC ratio calculated before consideration of the DTA leads to a measure of

[10] We recognize that the ability to generate future taxable income is also a function of future statutory book profits. The DTABG discussed the possibility of using various ways to estimate the present value of future profits. However, at this point in time, the practical considerations and complexities of implementing such an additional criterion for all companies necessitate that this approach not be undertaken.

capitalization that can be used to determine an appropriate charge to be applied to the DTA for the company. There is such a measure already in use that can be used for this purpose. Throughout the remainder of the report, we will refer to this ratio as the "Ex DTA RBC ratio."

B. DTA Impact on Surplus

If a company experiences operating or capital losses to such a magnitude as to render it insolvent, it is likely that a significant portion of the DTA would be unrealizable. The nature of the DTA is such that this is an escalating risk as losses increase – operating and capital losses generate increasing DTAs, making the DTA an even larger portion of a weakened company's balance sheet, before considering the impact of the admissibility rules.

The DTA, without safeguards, could continue increasing in value as a company's performance worsens up until the point the company's situation makes the asset unrealizable; forcing a write-off of what has become an ever more significant portion of the company's surplus and assets. However, under statutory accounting principles, the reporting company must make a determination at every reporting date as to the realizability of the DTA through the valuation allowance determination, that is, is the DTA more likely than not to be realized.

To illustrate the impact of the DTA on a company's balance sheet relative to its financial strength, we aggregated data for companies from the statutory annual statements filed with the NAIC and grouped individual companies (e.g., looking at individual NAIC companies, not group level results) based on their ratios of Total Adjusted Capital to Risk-Based Capital. The reported gross DTA in the annual statement is *before* the valuation allowance.

We grouped companies into four categories:

- *Below 100% of ACL* - Companies whose Total Adjusted Capital is less than their Authorized Control Level Risk-Based Capital
- *Between 100% And 200% of ACL* - Companies whose Total Adjusted Capital is less than their Company Action Level but above their Authorized Control Level Risk-Based Capital
- *Between 200% and 300% of ACL* – Companies whose Total Adjusted Capital is less than 150% of the Company Action Level (300% of the Authorized Control Level) but above their Company Action Level
- *Above 300% of ACL* – Companies whose Total Adjusted Capital is greater than 150% of the Company Action Level (300% of the Authorized Control Level)

The 300% level was selected to correspond with the level noted in the NAIC P&C Trend Test for RBC.

C. Property and Casualty Insurance Companies

This table shows the average of the DTA as a percentage of surplus, treating all P&C companies equally regardless of size for each level of capitalization noted above. Note that only the admitted portion of the DTA is included in surplus. Note also that companies with negative surplus are excluded here as the averages as calculated would be distorted.

2009 Average DTA as % of Surplus (P&C Companies)

Capitalization (as a % of ACL)	# Cos	Admitted	Non-Admitted	Total DTA
Below 100%	34	2.4%	137.8%	140.1%
100% to 200%	29	7.1%	12.4%	19.5%
200% to 300%	100	5.3%	14.7%	20.0%
Over 300%	2385	3.7%	5.0%	8.7%

Source: SNL Financial

The table shows that the weaker capitalized P&C companies have significantly higher total DTAs relative to surplus. It also shows that through the combination of valuation allowances and the capping of DTA admissibility, there is a significant component of the DTA that is excluded from statutory surplus. More than 98% of the total DTA is non-admitted for companies below the Authorized Control Level. For those companies whose capitalization exceeds the RBC threshold in the NAIC's trend test (300% of ACL), 57% of the DTA is non-admitted.

With regard to the admitted portion of the DTA, because there is no straightforward way to extract the valuation allowance out of the non-admitted DTA, it is difficult to say how much of the low admitted percentage for those companies below the ACL is due to the statutory caps under SSAP10R as opposed to how much is due to a valuation allowance. An NAIC data call would be expected to allow for a more detailed analysis of this issue.

As another gauge of reliance on DTAs, we attempted to reduce any potential impact of small P&C companies with large DTAs. To that end, we also looked at the data by summing up the total DTA (admitted and non-admitted) for those companies in the given category of capitalization and divided that sum by the total surplus for those same companies. This approach gives more weight to larger companies. Note that companies with negative surplus are excluded here as the figures as calculated would be distorted.

2009 Total DTA / Total Surplus (P&C Companies)

Capitalization (as a % of ACL)	# Cos	Admitted	Non-Admitted	Total DTA
Below 100%	34	0.8%	166.5%	167.2%
100% to 200%	29	3.9%	25.9%	29.9%
200% to 300%	100	3.0%	23.7%	26.6%
Over 300%	2385	4.5%	2.7%	7.2%

Source: SNL Financial

While the figures are somewhat different, the general conclusions are the same. It would appear that weaker P&C companies have significantly higher DTAs than stronger companies. Again, as noted above, it is not possible to tell whether the relatively low percentage of admitted DTAs is due to the valuation allowance or the statutory caps.

This would appear to confirm that P&C companies with weaker capital positions, perhaps because of operating or capital losses generating DTAs, would have a more material reliance on the DTA if it were fully admitted.

See Appendix 3 for additional P&C data.

D. Life Insurance Companies

The following table shows the average DTA, calculated without regard to size of company, as a percentage of surplus. Values are shown for admitted, non-admitted and total DTA. Note that the Total DTA amount is before any valuation allowance.

2009 Average DTA as a % of Surplus (Life Companies)				
Capitalization (as a % of ACL)	**Admitted**	**Non-Admitted**	**Total DTA**	**Number of Companies**
Below 100%	0.4%	105.2%	105.5%	3
100% to 200%	10.1%	151.8%	161.9%	5
200% to 300%	4.0%	80.5%	84.6%	16
Over 300%	5.8%	16.8%	22.6%	793

Source: SNL Financial

This table shows that the total DTA, in general, rises as the company becomes weaker but the pattern is less clear than it is for P&C companies. The main reason for this difference is likely the relatively small universe of weaker life companies. Due to the small number of companies in the weaker categories it is difficult to draw meaningful conclusions.

See Appendix 4 for additional life company data.

E. Health Insurance Companies

This table shows the average DTA as a percentage of surplus, treating all health companies equally regardless of size. The data is extracted from NAIC filings and therefore, counts each subsidiary as one company.

It is clear from the table below that the weaker capitalized health companies have significantly higher total DTAs relative to surplus. It is also clear that the overall admissibility limits result in a significant component of the DTA being excluded from statutory surplus for the weaker health companies. For those companies below the Authorized Control Level, 100% of the DTA is non-admitted. For those companies whose capitalization exceeds 300% of ACL, 70% of the DTA is non-admitted.

2009 Average DTA as % of Surplus (Health Companies)

Capitalization (as a % of ACL)	#Cos	Admitted	Non-Admitted	Total DTA
Below 100%	7	0.0%	62.7%	62.7%
100% to 200%	29	3.3%	10.4%	13.7%
200% to 300%	76	2.0%	11.6%	13.7%
Over 300%	648	2.0%	5.2%	7.2%

See Appendix 5 for additional health insurance data.

VIII. Special Considerations

This section covers four topics of special interest: Tax Sharing Agreements, Relationship of RBC Tax Adjustment and RBC on DTA, Value of the DTA in a Sale and Fraternal Considerations.

A. Tax Sharing Agreements

Statutory accounting (STAT) follows GAAP concepts with respect to members of a group that file a consolidated tax return. GAAP, and therefore STAT, provides that the consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. The method adopted shall be systematic, rational, and consistently applied.

SAP departs from GAAP with respect to the admittance of deferred taxes. In calculating the portion of DTAs that are admitted, an insurance company considers the impact of consolidation only with respect to carrybacks. DTAs admitted related to subsequent year taxes are admitted based upon stand alone principles.

DTAs Admitted through Carrybacks

Once the amounts of current and deferred taxes are determined in accordance with the tax sharing agreement, the amount of DTAs that can be admitted is determined. SSAP 10(R) paragraph 11c places limits on the amount of carryback potential that may be considered in calculating the gross DTAs of an insurance company that files a consolidated income tax return with one or more affiliates. In this case, the gross DTA may not exceed the amount that the insurance company could reasonably expect to have refunded by its parent.

The guidance on determining the admissible portion of the DTA in this situation is further clarified in Question 8.2 of the Questions and Answers associated with SSAP 10(R). Question 8.2 makes it clear that the amount that can be admitted can be no greater than the amount of taxes paid by the insurance company in the prior years. This provides a level of conservatism in the amount of taxes that can be admitted. Even though an insurance company might reasonably expect to have refunded an amount greater than the taxes it previously paid, the amount that can be admitted is limited to the amount of taxes it previously paid.

Furthermore, the company must consider the recoverability of taxes paid through a parent. In doing so, an insurance company must first consider whether it has received payment from its parent in accordance with the tax sharing agreement. Any payments owed to the insurance company, with respect to the tax sharing agreement, that are outstanding 90 days after the written agreement due date shall be nonadmitted in accordance with paragraph 13 of SSAP 10(R). If an insurance company has to nonadmit its current tax receivable it would also have to nonadmit its deferred tax asset related to a carryback since it would not be able to meet the reasonably expected to recover guideline.

Subsequent year(s) taxes

Tax sharing agreements do not impact the calculation of this portion of the admitted DTAs. Question 8.3 of the Questions and Answers provides that these calculations are to be done on a separate company basis. Question 8.3 further provides that an insurance company that projects a tax loss in the following year (3 years for SSAP 10(R)) cannot admit a DTA related to the loss, even if the loss could offset taxable income of other members in the consolidated group and the insurance company could expect to be paid by its parent for the tax benefit pursuant to the tax sharing agreement.

This provision is also conservative since the company will record the asset as a current tax receivable in the next year in accordance with the tax sharing agreement. With this conservatism it provides additional protection that the DTA will be realized and available to meet liquidity needs.

Other Safeguards

There are additional safeguards in the admittance of DTAs for insurance companies that are members of a consolidated group that assure that a conservative approach is taken. These safeguards are as follows:

- Tax sharing agreements must be systematic, rational, and consistently applied.

- If the parent is unable to meet its obligations under the tax sharing agreement or has no intention to comply with the tax sharing agreement, the portion of the gross DTA that is dependent upon the parent's payment would no longer be considered a good asset and would be treated as a reduction from stockholders equity. This has the same effect on equity as a valuation allowance against the DTA.

Summary

In summary, insurance companies that are members of a consolidated group admit DTAs based on:

- The amount reasonably expected to be refunded by its parent in accordance with the tax sharing agreement but no greater than the amount they previously paid. This is conservative since the insurance company could reasonably expect to have refunded an amount greater than what they previously paid in certain situations.
- The amount expected to be realized within one year (three years under SSAP 10R) based on a separate company analysis. This is also conservative since the insurance company could reasonably expect to realize additional amounts from its parent in accordance with the tax sharing agreement in certain situations.

Minimal risk is added by tax sharing agreements. As documented above, DTAs would not be admitted if the parent was not complying with the terms of the tax sharing agreement. Current tax receivables and DTAs admitted in accordance with the tax sharing agreement are intercompany receivables. The NAIC recognizes the lack of risk in intercompany receivables by not requiring any risk-based capital charge for receivables from parents, subsidiaries and affiliates. Therefore, special considerations for tax sharing agreements are not needed in the determination of an RBC amount for DTAs.

B. Relationship of RBC Tax Adjustment and RBC on DTA

There exists a regulatory concern that has been expressed as follows:

> *"Since the purpose of the RBC formula is to trigger action for a weakly capitalized company, the RBC formula should be appropriate for a weakly capitalized company (e.g., trigger the action of developing a capital plan when the capital level relative to risk is weak). If a company at this level often cannot make use of tax credits, then tax credits should be minimal in the RBC formula."*

For purposes of this statement, the term, "tax credits" is assumed to mean the explicit tax offset factors in the current life insurance company RBC formula.

This concern is related to the major risk associated with the admitted DTAs, i.e., that there may not be sufficient future taxable income in the insurance company to take advantage of the tax deductions inherent in those reported DTAs.

However, this issue differs in concept and application from the subject of the charge to our group, i.e., the recommended impact of DTAs on the RBC formula. The tax offset factors in the

RBC formulas generally attach to *future* cash flow items. On the other hand, the DTA values generally arise from sources which *exist at the time the statement is constructed.*

Furthermore, the tax offset factors in the RBC formula vary by company type (Life, P&C and Health). This means that this issue could not in any event be addressed through a single DTA "RBC-dependent" factor that is the same in all three formulas. A more global approach, covering all three formulas, would be needed and the RBC formula itself would have to change in ways that are not related to DTAs.

As a result of these considerations, this issue is not within our scope, given the CADTF charge to the DTABG. Our understanding is that the SMI subgroup of the Capital Adequacy Task Force is considering ways to modernize the RBC formula. That would appear to be where this regulatory concern can be explored.

C. Value of the DTA in a Sale

Tax regulations regarding an acquiring company's ability to monetize the target company's DTA are specific to the situation of the acquisition, the nature of the DTAs on the target company's books, the price paid for the target company, and the resulting impact on the acquiring company's DTA.

Per "Tax Management Portfolios – Net Operating Losses and Computations"[11]:

> *Because a net operating loss is deductible only by the taxpayer sustaining the loss, it is generally not possible to transfer the tax benefit of a net operating loss deduction from one taxpayer to another. Corporate reorganizations, however, provide a potential opportunity for abuse of the net operating loss deduction. Absent restrictions, the scenario would entail a profitable corporation acquiring an unprofitable corporation with unused net operating loss carryovers. If the acquiring corporation succeeds to the net operating loss carryovers of the acquired corporation, those carryovers can be used to offset future taxable income of the acquiring corporation. Sections 381, 382, and 269 are designed to curb the potential abuses associated with such "trafficking in loss corporations"*

Generally speaking, IRS rules are established to hinder "trafficking" in DTAs by limiting the acquiring company's ability to monetize DTAs associated with net operating losses to a function of the purchase price times the long-term tax-exempt rate. In essence, this limits the additional deductions the acquiring company can monetize to what they would be able to achieve if they were simply investing the purchase price in tax-exempt securities. IRC Section 383 has similar restrictions associated with the ability to monetize capital loss carry forwards.

The valuation allowance should recognize a company's ability to recognize any ordinary or capital loss carry forward in light of IRS limitations. As such, in the situation where a company is distressed (whether the situation is caused by net operating losses or capital losses) the value of the admitted DTA should reflect any such limitation on the ability to monetize the DTA.

[11] "Net Operating Losses – Concepts and Computations"; Tax Management Portfolios 539, 2nd Edition; Freitag

Similarly, should a healthy insurer be acquired, the ability or inability on the part of the acquired company to realize the value of its DTA should be explicitly recognized in the calculation of the company's valuation allowance.

DTAs existing due to temporary differences such as loss reserve discounting would continue to persist post-acquisition, as these are the result of anticipated future deductions to taxable income, but would be subject to existing statutory caps as detailed in SSAP 10 / 10R.

Ideally, our analysis would include the post-acquisition impact on DTAs. However, the data is not publicly available and not practical to obtain. To obtain such data would have required interviews with acquiring companies who would have been willing to share proprietary information, such as their tax planning strategies.

Thus, since IRS rules limit the ability of an acquiring company to monetize an acquisition's carry forwards, we do not believe the approach to calculating an RBC charge for DTAs we have proposed here should be modified to reflect potential realization of these assets in a sale.

D. Fraternal Considerations

Because the tax situation is different for fraternal insurance companies, we gave special consideration to fraternals in our work, at regulator request.

We understand the interest of regulators to be sure that the special situation of fraternals is considered, given the situation when taxes became part of the life formula in 2001. At that time, the life RBC factors were grossed up and tax factors incorporated to return the RBC calculation to roughly the same place for most companies. However, since RBC factors for fraternals followed the life formula, and the fraternals had no tax offset, the grossed up factors for life resulted in a significant increase in RBC for fraternals. Subsequently, through the Life RBC Working Group, adjustment factors were inserted in the fraternal formula, based on the fact that fraternals must distribute a percentage of their "pre-tax" gain to maintain their fraternal status. This restored the fraternal RBC calculation to an amount that was comparable to the pre-2001 level.

As noted above, fraternal companies do not pay federal income tax. As a result, there is no basis for a deferred tax asset, and, in fact, there are no DTAs on fraternal company statements. Furthermore, we note that there is no provision for a "fraternal contributions" counterpart to a DTA. As a result, there is no need for an RBC charge in the fraternal formula for DTA or DTA-like assets.

IX. Recommendations

As a result of these analyses, the DTABG recommends that:

- The amount of the RBC charge reflect a company's capitalization, as measured by the RBC ratio before any adjustment for DTAs (with certain other adjustments);
- The RBC charge be placed in a portion of the RBC formula that is outside the covariance formula (C-0 for life, R-0 for P&C, and H-0 for health);

- The effect of the charge should eliminate the benefit of DTAs (including the portion supported by past taxes paid) in calculating an RBC ratio for companies with an Ex DTA RBC ratio of less than 200% of ACL and should provide for a minimum RBC charge of 0% or 1% of the DTA supported by future taxes for companies with an Ex DTA RBC ratio over 500%, depending on the admissibility limits placed on the DTA.

A. Placement of the charge

This charge should be placed in a part of the RBC formula that is outside of the covariance adjustment. This is because any one of the risks in the RBC formula also represents a risk to the ability to realize the DTA. For this reason, it seems appropriate for the DTA risk charge to be a direct addition to the otherwise indicated RBC amount. For life this would place it in C-0; for P&C in R-0; and, for health in H-0.

B. RBC charge should reflect a company's level of capitalization

Because the principal concern underlying the rationale for the statutory caps is an over-reliance on the DTA for companies in or near an RBC action level, the DTABG believes an appropriate approach would be a variable risk charge applied to the DTA with those charges increasing as the capitalization of the company decreases.

While the valuation allowance itself should implicitly consider a company's ability to realize the DTA, a tiered charge resulting in a 100% (or more) charge against the DTA for companies in a more hazardous position would essentially remove any benefit from the DTA regardless of realization estimates for those companies.

The size of the risk charge will be based on the calculation of an Ex DTA RBC ratio. For the purpose of these calculations we suggest that this ratio be calculated the same way that a ratio is calculated for purposes of determining the limits on admitted DTA today, as defined in SSAP10R. In other words, "Adjusted Capital" (in the numerator of the ratio) would be reduced by the sum of the amount of admitted DTA, the amount of EDP / Operating System Software, and the amount of net positive Goodwill. The denominator would be the ACL RBC amount prior to any adjustment for DTAs; that is, excluding any amount associated with the DTA.

C. The minimum RBC charge should be applied to the amount of the DTA that is supported by future taxable income (covered DTA amount)

The DTABG also recommends no risk charge for that portion of the DTA arising from temporary taxable differences supported by taxable income in prior carry back years for companies with Ex DTA RBC ratios over 500% of ACL. For these companies, the realization of that component of the DTA entails little risk. We think the portion of the DTAs supported by carry backs are of comparable risk to the credit risk on a US Treasury note (i.e., no risk charge), as the risk is a matter of timing, not of realization or counter-party credit risk. In the remainder of this report, we refer to the amount of DTA backed by future taxes as the "covered DTA amount."

D. Factor Development

In developing a factor to be applied to the DTA amount we began by considering the situation in the absence of limits on DTAs. Our approach was to develop two anchor points, starting with the determination of an appropriate factor for companies with Ex DTA RBC ratios over 500% of ACL.

As noted above, the key risk to DTAs is the possibility of default of the company, thereby rendering the DTAs worthless. This risk is similar to the risk posed by a bond issued by the same company. As a result, it was decided that, for companies with Ex DTA RBC ratios over 500% of ACL, the factor for asset class 1 bonds, 0.4%, was a good place to start. Asset class 1 includes class A, AA, and AAA rated bonds and a 500% of ACL RBC ratio is not inconsistent with this class. Recognizing that certain risks were not considered and to add some conservatism, we increased this amount to 1%. This 1% assumption is moderately conservative relative to the estimated current effective rate in the P/C RBC formula. Note that this amount is only applied to the covered DTA amount and assumes full admissibility of the adjusted gross DTA; i.e., SSAP10 and 10R capping procedures are eliminated. If current (or similar) capping procedures are maintained, it is recommended there should be no charge in the RBC formula for these companies (see item F, following).

Next we considered an appropriate factor for companies with Ex DTA RBC ratios of 200% of ACL or less. At this point, it was decided that the company should get no credit for any DTAs in the RBC formula. This means that Total Adjusted Capital should be reduced for the amount of any admitted DTA. Likewise, the company would not add anything to the calculated RBC amount in the denominator.

A third reference point was established for companies with Ex DTA RBC ratios of 300% of ACL. This level is the top end of the trend test level for P&C companies. The asset class 1 bond factor seemed too low for these companies as they are likely riskier than those companies with Ex DTA RBC ratios of 500% of ACL. As a result, we based the factor for a company at this level on the asset class 3 bond factor of 4.6%. To reflect risks not directly considered, we raised this factor to 5%

Between these three levels we decided that a pattern of charges should be established that moves smoothly from one level to the other. We determined that the best way to do this was with the combination of a varying charge and a floor amount. The floor amount is 1% of the Covered DTA amount (assuming the caps on DTAs are eliminated). To grade smoothly in between the two endpoints we linearly interpolated from the 50% factor required to eliminate the effect of the DTA when the Ex DTA RBC ratio is 200% of ACL and the 5% factor for companies with an Ex DTA RBC of 300% of ACL. For Companies with Ex DTA ratios between 300% and 500% of ACL the charge is interpolated from 5% at the low end to 0% at the high end (noting that this amount is floored at 1% of the Covered DTA Amount assuming capping procedures are eliminated). This results in the following formula description, based on the Ex DTA RBC ratio:

Calculate the Ex DTA RBC ratio as noted above.

If the Ex DTA RBC ratio is < 200% of ACL, then the amount of the admitted DTA is subtracted from TAC and no additional RBC amount is added to the RBC amount. This means that the RBC ratio ≈ the Ex DTA RBC ratio.

If the Ex DTA RBC ratio is > 200% of ACL but less than 300% of ACL, the RBC charge for DTA is:

$$RBCF^{DTA} = (50\% \times \left(300\% - RBCR^{ExDTA}\right) + 5\% \times (RBCR^{ExDTA} - 200\%))$$

If the Ex DTA RBC ratio is > 300% of ACL but less than 500% of ACL, the RBC charge for DTA is:

$$RBCF^{DTA} = (5\% \times \left(500\% - RBCR^{ExDTA}\right)) / 2$$

but not less than 1% of the Covered DTA Amount.

Under this approach, companies with an Ex DTA RBC ratio of 200% of ACL or less would derive no benefit from DTAs. Companies with an Ex DTA RBC ratio over 500% would have an RBC charge of 1% of the Covered DTA Amount (assuming elimination of current capping procedures) and companies in between those two levels would have a charge that grades uniformly from one extreme to the other, depending on the Ex DTA RBC ratio.

E. Charge when Limits are Present

As noted earlier, the DTABG does not believe an RBC charge is necessary for companies with an Ex DTA ratio of 500% or more when there are admissibility limits imposed on the adjusted gross DTA As a result given the limits in the current calculation of DTAs, we believe that the floor of 1% in the formula given no limits should be 0% if limits are retained. This will retain the concept of diminishing benefit for DTA as a company becomes weaker but avoids the double counting presented by both a limit and an RBC charge for stronger companies.

As described earlier and illustrated in Appendix 2, the 2009 admissibility limits on the DTA are in effect an RBC charge against the entire DTA. For life insurance companies, the equivalent RBC charge is 14%, outside of any covariance. For P&C companies, the equivalent RBC charge is 13%, outside of any covariance adjustment. For health insurance companies, the equivalent RBC charge is 24%, outside of any covariance adjustment. Also, the current admissibility limits result in a large percent of the total DTA being non-admitted. As stated earlier, in 2009, the first year that the expanded limits were fully available, 60% of the total DTA within the life industry was non-admitted. The comparable number for P/C companies was 49%; for health insurers, 74%. In 2007, the last year when the new limits were not available to any company, the non-admitted portion for the life industry was almost 70%. The comparable number for P/C companies was 57%; for health insurers, 78%.

Some members of the DTABG expressed a strong preference for an explicit risk charge as opposed to an implicit risk charge embedded within the statutory caps. From the perspective of a clearer and reasonable RBC approach, some members of the group believe that removing the implicit risk charge in statutory accounting and replacing it with an explicit RBC risk charge

would have benefits. The rationale is that this would be consistent across companies, reasonably recognize the risk, and provide a more transparent view of the risk charge applicable to DTA. The DTABG recognizes that changes in statutory accounting may have broader ramifications than simply their use in the RBC calculation but has not researched any such impacts.

F. Additional Considerations Regarding DTABG Proposal

The DTABG noted and discussed issues likely to be raised regarding these recommendations. The DTABG encourages the NAIC to fully debate these issues and any others raised. However, after considering these issues, the DTABG adhered to its view that the proposed approach is reasonable and practical given the unique nature of the DTA. Alternatives discussed by the DTABG were considered to have arguably greater problems.

In particular, two issues are discussed here:

1. *Use of the RBC model as a means of identifying weaker companies and as a measure of relative company strength among them, potentially expanding the role of the model beyond the original stated intent.*

As noted previously, the principal risk associated with the realization of the DTA is the ability to earn enough taxable income of the right character to be able to recognize the value of the DTA. The DTABG feels this is a function of the company's viability as an ongoing concern, which in turn is a function of its capitalization.

Given this, the DTABG discussed alternative approaches to measuring capitalization, such as agency ratings, bond spreads for the company's debt and credit default swaps (CDS) pricing. Agency ratings were considered insufficient for this purpose as many companies are not rated, and those that are rated may have inconsistent ratings from different rating agencies, leading to the problem of determining criteria for use of rating agency indications. It was observed that bond spreads and CDS pricing are volatile and frequently shift for reasons other than company-specific issues, and as such were felt to be inappropriate for this purpose. Additionally, not all insurers have publicly traded debt or available CDS pricing.

As such, 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 does, however, believe the RBC model is an effective basis for the purpose at hand.

2. *Increasing the charge as a company's capitalization deteriorates will accelerate declines in a company's RBC ratio.*

This was discussed by the DTABG and its related committees and is a valid concern regarding the recommendations in this report. Decreasing the RBC ratio due to increasing the DTA-related RBC charge as the company's capitalization decreases is sometimes referred to as pro-cyclicality (although this relates to the circumstances of particular companies, not the insurance cycle, per se).

However, if it is agreed that the risk of a company's viability increases as the RBC ratio decreases and that the realizability of the DTA is dependent on company viability, then it is reasonable to conclude the charge should increase under these circumstances. The DTA is unlike any other asset on the company's balance sheet in that the DTA's value is highly contingent on the company's viability going forward. As such, the nature of an appropriate charge within the RBC framework should exhibit the characteristic proposed here (although other approaches might be used to achieve similar results).

Additionally, this concern should be viewed in light of the current statutory accounting framework. Both the capping of the DTA as a percent of surplus and the limitation based on either 1 or 3 year realizability have similar impacts, likewise resulting in a decreasing RBC ratio under emerging adverse financial experience circumstances.

Should a company suffer operating or capital losses, the Gross DTA would typically increase. The Adjusted Gross DTA may not increase as much as the Gross DTA if an increased valuation allowance is deemed appropriate. However, a further reduction in the admitted value of the DTA takes place as the loss decreases surplus, potentially resulting in a reduced admitted DTA and lower surplus under current statutory accounting rules as a result of capping the DTA at a percent of surplus. Additionally, if the source of the losses is expected to inhibit future earnings (e.g., management forecasting higher claims costs as a result of adverse experience), it is likely surplus is further reduced due to the 1 year / 3 year realizability cap.

This results in downward pressure on the RBC ratio, not through an increase in the Authorized Control Level or Company Action Level, but rather through a decrease in both surplus and Adjusted Capital.

This issue can be further exacerbated by the Alternative Minimum Tax. Should a company find itself in a situation where it is expected to be subject to the AMT for the realizibility period, it would generally calculate its admitted DTA using the lower AMT rate as opposed to the higher corporate rate. This would result in a reduction in the admitted DTA under current rules, producing a lower Adjusted Capital in the RBC calculation.

While the DTABG recognizes the concern raised about the leveraging impact of the proposed risk charge, particularly in conjunction with statutory capping rules, the proposal is based on the conclusion that the DTA risk increases as capitalization declines, consistent with the rationale of current accounting procedures.

G. Alternative Approaches

There are alternatives that we evaluated but rejected as not being as comprehensive as our recommendation. These included:

- A differential charge for certain "persisting" differences between statutory income and taxable income (such as differences in reserve discounting and DAC), and a higher charge for those components of the DTA that are highly dependent on the company's ability to earn a profit in the future (such as capital or operating loss carryforwards).
- A differential charge based on timing of reversals to reflect increased uncertainty in future projection periods.
- An approach similar to that proposed in the December 2009 Basel Committee on Banking Supervision Consultative Document, "Strengthening the resilience of the banking sector" for the banking industry. This approach excludes those components of the DTA that are highly dependent on a company's ability to earn a profit in the future (such as capital or operating loss carryforwards) from Adjusted Capital, and applies a risk charge based on sovereign default risk to those temporary differences that could be considered prepayment of taxes (loss discounting, DAC).

Deferred Tax Asset Bridge Group Report
September 2010

Appendix 1
Sample DTA Calculation

Total Gross DTA		300					
Valuation Adjustment		20					
Adjusted Gross DTA		280					
Limit Calculation		This Year		Prior Year		Two years ago	
10ei	Taxes Paid	20		10		10	
		Next Year		In 2 Years		In 3 Years	
	Tax on Differences Reversing	63		56		42	
	Total Taxes Paid	40					
	Total Tax on Differences Reversing	161					
	Total 10ei amount (lesser of the two)	40					
10eii		Without Reversing Differences	With Reversing Differences	Without Reversing Differences	With Reversing Differences	Without Reversing Differences	With Reversing Differences
	Projected Taxable Income w/ reversing differences	300	300	100	100	100	100
	Reversing differences	180		160		120	
	Projected Taxable Income	480	300	260	100	220	100
	Tax @ 35%	168	105	91	35	77	35
	Difference in Tax		63		56		42
10eii	Calc	161					
	Less amount in 10ei	40					
	10eii amount before 15% limitation	121					
	15% of surplus	105					
	10eii Amount (lesser of the two)	105					
10eiii	Total DTA	280					
	Less (10a & 10b) / (10ei & 10eii)	145					
	Total DTA to offset DTL	135					
	Total DTL	70					
	10eiii amount (lesser of the two)	70					
Total Admitted DTA		215					
Non Admitted DTA		85					
Total DTA		300					

Deferred Tax Asset Bridge Group Report
September 2010

Appendix 2
Impact of admissibility limits
RBC charge on full DTA that equates to impact of current admissibility limits
Based on 2009 industry data (in $ millions)

	Life	Health	P&C
Adjusted Capital without DTA	269,050	74,411	613,939
DTA			
Admitted	33,533	2,157	27,592
Not admitted	49,811	6,279	20,902
Total	83,344	8,436	48,494
ACL RBC*	36,387	12,550	98,711
RBC ratio (vs Company Action Level)			
Without consideration of any DTA	370%	296%	311%
With limits on admissibility of DTA	416%	305%	325%
With total DTA	479%	330%	336%
RBC charge against the total DTA required to equate RBC ratio with current DTA admissibility limits to RBC ratio if full DTA admitted	14.3%	24.4%	13.3%

*This includes the current RBC charge against the admitted DTA. Therefore the RBC charge against the total DTA required to equate the RBC ratio with current DTA admissibility limits to the RBC ratio if full DTA is admitted is understated.

Deferred Tax Asset Bridge Group Report
September 2010

Appendix 3
Analysis of Statutory Data for Property / Casualty Insurance Companies

As discussed earlier in this report, one of the major sources of DTAs is differences between statutory and tax reserves. For the P&C industry this difference results primarily from loss reserve discounting and the disallowance of a portion of the unearned premium reserves for tax purposes. For these, we can arrive at what we would view as a reasonable estimate the impact of these at an industry aggregate level.

For UPR, statutory accounting includes the change in UPR during the year as a reduction in income, while acquisition expenses are deducted from income when the policy is written. For tax accounting, 20% of the change in UPR is treated as "revenue offset"; essentially attempting to recognize acquisition costs as the policy is earned, accelerating income recognition relative to statutory accounting.

Industry aggregate UPR as of 12/31/2009 was $199.4 billion. The revenue offset of 20% of UPR would be $39.9b. The tax effect of this temporary difference in earnings assuming a 35% tax rate would be $14.0b as a rough approximation to the revenue offset contribution to the DTA.

For loss reserves, tax accounting recognizes that loss reserves are not immediately payable and applies a discount (present value) factor based on the payout pattern associated with the liabilities and a 60 month rolling average of the Federal Mid-Term Rate to discount the cash flows. As with the revenue offset, this accelerates income recognition relative to statutory accounting.

If we take industry aggregate reserves by Schedule P line of business, and apply current Internal Revenue Service discount factors (per Rev. Proc. 2008-10, 2008-3 IRB 290, 12/18/2007, IRC Sec(s). 846), we estimate a blended tax discount factor of 0.907. Taken against industry aggregate net loss reserves as of 12/31/09 of $576.8 billion would imply a tax discount of $48.5 billion. Assuming a 35% tax rate, the gross DTA attributable to loss reserves is roughly $17 billion.

Note that the both the Revenue Offset and Loss Discount calculations are approximations. Individual company circumstances can result in different calculations and assumptions. For loss discounting as an example, the IRS allows the use of company-specific loss payout patterns. Additionally, the Federal Midterm Rate to be used in discounting varies by accident year. However we view these approximations to be reasonable at an industry aggregate level.

The following table shows a high-level view of the industry aggregate statutory annual statements for the Property and Casualty industry since 2003. Note that 2001 was the first year that the DTA was treated as a statutory asset (prior to codification, taxes were recognized on a cash basis, not on an accrual basis).

Property & Casualty Industry Aggregate Data ($mil)							
	2003	2004	2005	2006	2007	2008	2009
(1) Admitted DTA	16,442	17,495	18,803	17,866	18,446	24,936	28,332
(2) Non-Admitted DTA	22,245	22,244	23,045	22,164	24,081	38,645	27,330
(3) Total DTA	38,687	39,739	41,848	40,031	42,527	63,581	55,662
(4) Non-Admitted DTA / Total DTA	57.5%	56.0%	55.1%	55.4%	56.6%	60.8%	49.1%
(5) Net Admitted Assets	1,162,326	1,262,400	1,363,245	1,449,374	1,506,210	1,446,734	1,492,199
(6) Admitted DTA / Admitted Assets	1.4%	1.4%	1.4%	1.2%	1.2%	1.7%	1.9%
(7) Surplus	353,108	395,066	429,059	494,088	529,044	460,676	517,551
(8) Admitted DTA / Surplus	4.7%	4.4%	4.4%	3.6%	3.5%	5.4%	5.5%
(9) Non-Admitted DTA / Surplus	6.3%	5.6%	5.4%	4.5%	4.6%	8.4%	5.3%
(10) Total DTA / Surplus	11.0%	10.1%	9.8%	8.1%	8.0%	13.8%	10.8%
(11) Net Change in Unrealized (AFIT)	22,573	11,248	(8,750)	21,306	(1,910)	(59,231)	23,703
(12) Est Tax on Change in Unrealized	12,155	6,057	(4,711)	11,472	(1,029)	(31,894)	12,763
(13) Change in Total DTA		1,052	2,109	(1,817)	2,497	21,054	(7,919)

Source: SNL Financial

This leads to several high-level observations:

- Of the $55.7b in DTA as of 12/31/09, we estimate roughly $31b (discussed above) of the total asset is attributable to the temporary differences between statutory and tax accounting for loss discounting and the revenue offset.
- The admitted DTA makes up a relatively small portion of the P&C industry assets, with the admitted DTA averaging between 1-2% of admitted assets, and roughly 4-6% of surplus.
- Since the non-admitted component of the DTA began to be captured in the statutory annual statement in 2003 until 2008, it has remained a relatively consistent 55-60% of the total DTA (e.g. only about 40-45% of the total asset is considered admitted and included in Total Adjusted Capital for RBC purposes).
- In 2009, the non-admitted component of the DTA dropped to 49.1%, likely due to the increase in admissibility caps.
- Between 2001 and 2007, the admitted DTA for the industry in the aggregate has ranged from $14.6 b to $18.8 b. Between 2004 and 2007, the admitted DTA fell in an even narrower range, varying from $17.5b to $18.8b.
- In 2008, the DTA, both admitted and non-admitted, increased significantly over 2007, with the admitted DTA increasing $6.4b (from $18.5b to $24.9b) and the non-admitted DTA increasing $14.6b (from $24.0b to $38.6b), an increase in the total asset of $21.0b.
- In 2009, the admitted DTA increased $3.4b (from $24.9b to $28.3b), while the non-admitted DTA decreased $11.3b (from $38.6b to $27.3b), a decrease in the total asset of $7.9b.

We believe the biggest driver of the 2008 increase in DTA to be the change in unrealized losses for the industry of $60b after tax (line 11 in the table above). Because, for tax purposes, the loss cannot generally be recognized until realized, a DTA would be established to accrue for the

reduction in tax liabilities associated with the loss. This DTA, in essence, results in the unrealized losses being tax-effected.

If we assume a tax rate of 35% for the industry the pre-tax change in unrealized for 2008 would be approximately $91.1b ($59.2b / (1-35%)), implying an associated tax benefit of $31.9b ($91.1b pre-tax less $59.2b after-tax). Note that this tax benefit of $31.9b is coincident with the significant increase in DTA of $21.0b (line 12 vs. line 13).

Similarly, we believe the biggest driver of the 2009 decrease in DTA to be the change in unrealized gains of $23.7b. Utilizing the same calculation, we estimate the implied deferred tax costs associated with the gains at $12.8b, as compared to a change in DTA of $7.9b.

Clearly there are other moving parts in the calculation of the DTA that complicate any full reconciliation of the sources of the DTA, but these results indicate that the volatility in the investment markets in 2008 drove the significant increase in industry DTA.

Deferred Tax Asset Bridge Group Report
September 2010

Appendix 4
Analysis of Statutory Data for Life Insurance Companies

The following exhibit shows some key historical results regarding the use of DTAs.

EXHIBIT 1

	2003	2004	2005	2006	2007	2008	2009
(1) Net Admitted DTA	14,145	13,793	13,905	14,266	15,491	23,010	33,533
(2) Non Admitted DTA	28,988	32,617	34,451	35,131	35,147	67,035	49,811
(3) Total DTA	43,133	46,410	48,356	49,397	50,638	90,045	83,344
(4) Admitted DTA/Total DTA	32.8%	29.7%	28.8%	28.9%	30.6%	25.6%	40.2%
(5) Net Admitted Assets	3,799,116	4,152,235	4,389,360	4,723,175	4,989,954	4,549,086	4,761,332
(6) Admitted DTA/Adm Assets	0.37%	0.33%	0.32%	0.30%	0.31%	0.51%	0.70%
(7) Surplus	224,287	237,275	247,006	254,217	269,117	252,459	285,599
(8) Admitted DTA/Surplus	6.3%	5.8%	5.6%	5.6%	5.8%	9.1%	11.7%
(9) Non-Admitted DTA/Surplus	12.9%	13.7%	13.9%	13.8%	13.1%	26.6%	17.4%
(10)Total DTA/Surplus	19.2%	19.6%	19.6%	19.4%	18.8%	35.7%	29.2%
(11)Net Change, Unrealized (AFIT)	8,613	-1,589	1,755	2,750	-2,548	-15,427	-9,751
(12)Change in DTA		3,277	1,946	1,041	1,241	39,407	-6,701
(13) Est Tax on Line (11)@(.35/.65)	4,638	(855)	945	1,481	(1,372)	(8,307)	(5,250)

Source: SNL Financial

Data Limitation

Line 1 of Exhibit shows a rapid increase in the net admitted DTA for both year ends 2008 and 2009. The changing rules regarding the caps on admitted DTAs played a substantial role in this change. For year-end 2008, the year prior to the promulgation of SSAP 10R, eleven states nonetheless granted permitted practices to many of their domiciled life insurance companies to adopt the following liberalizations of SSAP No. 10:

- SSAP No. 10, paragraph 10a was changed to allow for 3 years of temporary difference reversals to be taken into consideration, instead of 1 year.
- SSAP No. 10, paragraph 10b was similarly changed from 1 year to 3 years; additionally, the limitation with respect to the percentage of surplus permitted was increased from 10% to 15%.

For year end 2009 this liberalization was extended to all life insurers that passed the 250% test on ACL RBC, albeit with the following offsetting items:

- A valuation allowance was made explicit, to account for situations where the availability of recovery did not pass the "more-likely-than not" test.
- The Ordinary vs. Capital character issue was to be strictly followed.
- The liberalization was elective, and not all companies elected it.

Nevertheless, this amounted to a substantial net liberalization and increase in net admitted DTA on the whole for 2008 and 2009. Line 2 (Non-admitted DTA) experienced a consequent decrease. As a result of these changes, it is difficult to illustrate direct relationships between the DTA and various drivers. However, we can qualitatively note the drivers of DTA changes.

Aggregate Trends

As discussed earlier in this report, the major sources of deferred tax assets (DTAs) for life insurance companies are the following:

(i) Excess of statutory reserves over tax reserves
(ii) The 'Tax DAC' ("proxy" deferred acquisition expenses pursuant to Code Section 848)
(iii) Unrealized capital losses

The excess of statutory reserves over tax reserves creates a reduction in statutory income that is not reflected in the tax returns. Reflecting the proper tax adjustment in this situation creates a DTA. This source of DTA is reasonably predictable except for those statement dates where excess asset adequacy reserves must be established. This is rarely a significant item in the aggregate except for times when the entire economy is experiencing financial distress.

The 'Tax DAC" proxy creates a tax at the issue date of a policy or contract is issued, and which is repaid over time. As a result, it creates a DTA which represents what the company will be repaid over time. This DTA amount is extremely predictable, inasmuch as the capitalization rate is a prescribed percentage of premiums and, by and large, amortizes in a straight-line fashion over 10 years.

Unrealized capital losses represent losses that have been reflected in the statutory statement but not in the tax returns. Again, proper reflection of the tax situation creates a DTA. This DTA amount is highly dependent on the state of the economy and arguably the most unpredictable of these three major sources.

As indicated above, sources (i) and (ii) are functions of reserves and premiums respectively, as illustrated historically in the table below for the life insurance industry as a whole (figures in USD billions). Ordinary Life and Ordinary annuity are the largest drivers of the Tax DAC.

EXHIBIT 2
Life Industry Reserves and Premiums ($billion)
Source: SNL Financial

	2004	2005	2006	2007	2008	2009
Year End Aggregate Reserves						
Life	1,800	1,874	1,904	1,910	2,030	2,056
Accident & Health	128	136	147	161	180	184
Total	1,928	2,010	2,051	2,071	2,210	2,240
Premium Income, Ordinary						
Life	107	108	110	101	114	90
Annuity	167	163	183	188	203	119

This Exhibit shows that both the reserves and premium income were out of pattern on the low side in 2009. This would have been expected to lead to a drop in DTA, absent the change in the caps.

As noted above, unrealized capital losses are also a key source of DTAs.

Line 11 of Exhibit 1 shows the change in the net unrealized capital gains (i.e., unrealized capital gains less unrealized capital losses). Note that net capital losses increased in 2008 by $15 billion and continued to increase in 2009, whereas for property/casualty insurers net capital losses decreased in 2009. The increase in 2009 is somewhat counterintuitive, and may be related to the impact of derivatives used to hedge market risk. As the markets went up, the value of these derivatives went down. In addition, there are a number of other points to consider in the different incidence of statutory asset deterioration between life insurers and property/casualty insurers:

- High quality bonds are generally valued at amortized cost, while lower quality bonds are valued at the lower of cost or market (LOCOM). While for property/casualty insurers NAIC asset classes 3 through 6 are valued at LOCOM, for life insurers only class 6 is valued at LOCOM. The depth of the financial crisis was March, 2009, so that, the rate of deterioration in statutory asset balances by calendar year could indeed be different between property/casualty insurers and life insurers. Thus as assets deteriorated through the NAIC classifications, this would be an explanation for the later effect of deterioration for life insurers. (For example, deterioration from class 2 to 3 would be felt by property/casualty insurers but would not be felt by life insurers until the asset reached class 6.)
- In general, life insurer asset durations tend to be longer than property/casualty insurer asset durations, due to the types of liabilities that they support. Thus it is possible that the deterioration rate per dollar of par value might be more significant for life insurers.

In total, the DTA decreased by $10 million in 2009. There are several likely reasons, including the following:

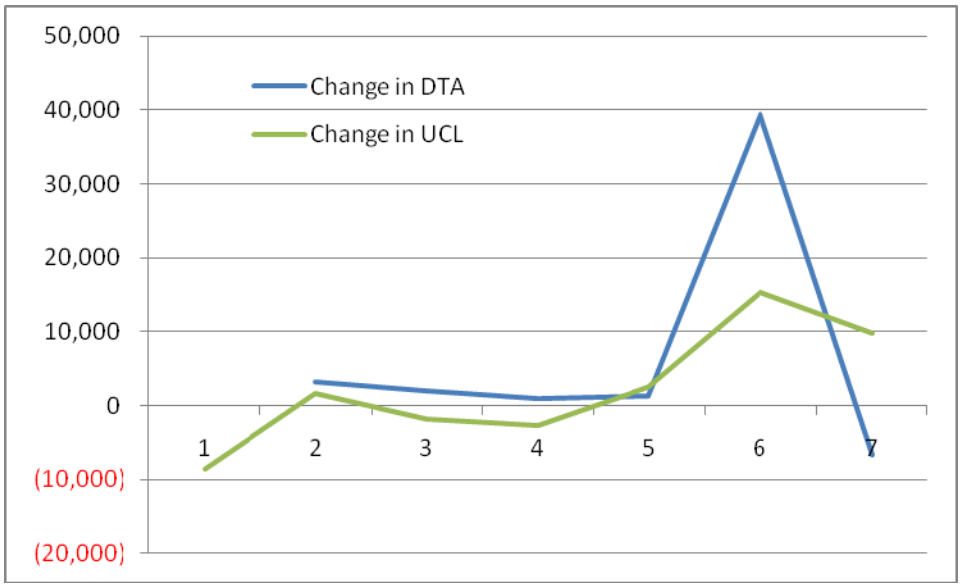
- The decline in new ordinary premium as shown in the above table, which reduced new Tax DAC capitalization and consequently reduced the DTA
- The slowing of the aggregate non tax deductible reserve increases, in part due to two drivers:

- The significant release of year end 2008 asset adequacy reserves.
- A liberalization of the X-Factor generation rules applicable to alternative minimum reserves under the Appendix A-830 of the NAIC Accounting Practices and Procedures Manual. That should cause a substantial decrease in deficiency reserves from YE08 to YE09.

- The replacement of large statutory-to-tax reserve differences (for policies issued primarily from 1988 to approximately 2003) with smaller such differences (for more recent such issues), as the excess of the tax basis valuation interest rate (Applicable Federal Interest rate) over the statutory valuation interest rate has declined from over 300 basis points to virtually zero.

Exhibit 3 shows the positive correlation between the change in unrealized capital losses and the change in the net DTA. As indicated above, unrealized capital losses are a major source of DTA but not the only source. However, unrealized capital losses have recently been the most volatile of the three major sources.

EXHIBIT 3



Source: SNL Financial

To summarize, we can make the following statements about the DTA relative to other items in the statutory balance sheets:

- The admitted DTA is a very small percentage of admitted assets but increasing due to the advent of SSAP 10R.
- Even with the increased admissibility of the DTA, the admitted net DTA currently comprises only about 40% of the total net DTA.
- The ratio of admitted net DTA to surplus has risen to 12% overall. However, this statistic varies widely by company and thus should not be taken out of context as an indicator of relative solidity for the industry. This statistic should be viewed on a company-by-company basis.

Deferred Tax Asset Bridge Group Report
September 2010

Appendix 5
Analysis of Statutory Data for Health Insurance Companies

The Health Solvency Work Group reviewed available statutory annual statement data to evaluate the characteristics of the DTA and its dynamics over time.

Health Industry Aggregate Trends

As discussed earlier in this report, one of the major sources of DTAs is differences between statutory and tax reserves. For the Health industry, the primary drivers of DTAs include:

- Unpaid loss reserve discounting;
- Accruals that are not deductible for tax purposes until paid;
- Deficiency reserves that are not deductible until the loss is realized; and
- The 20% unearned premium haircut.

As with other product lines, one of the major sources of DTAs for the Health industry relates to differences between statutory and tax reserves. This results primarily from two sources: (1) differences in statutory and tax discount rates and (2) the non-deductible nature of premium deficiency reserves for tax purposes. The impact is amplified for Long Term Care (LTC) and other long-tailed products.

LTC products generate substantial reserves to cover benefits that stretch several years into the future. Because the tax reserves are calculated utilizing less conservative discount rates, there tends to be a substantial difference between the statutory and tax reserve levels. This difference in reserve levels accelerates income recognition relative to statutory accounting.

Per SSAP #54, premium deficiency reserves (PDRs) must be established "when the expected claim payments or incurred costs, claim adjustment expenses and administration costs exceed the premiums to be collected for the remainder of a contract period." Given the structure and relative newness of LTC products, PDRs are often required and can be quite substantial for older blocks of business. Because PDRs are not a tax-deductible liability, taxable income is accelerated relative to statutory income creating a need for DTAs.

The following table shows a high-level view of the industry aggregate statutory annual statements for the Health industry since 2004. The probable cause of the increase in DTAs in 2008 was unrealized capital losses.

Deferred Tax Asset Bridge Group Report
September 2010

Health Insurer Historic DTA(in $millions)							
		2004	2005	2006	2007	2008	2009
(1)	Admitted DTA	1,004	1,362	1,390	1,651	1,975	2,157
(2)	Non-Admitted DTA	2,237	4,336	5,092	5,907	7,819	6,279
(3)	Total DTA	3,241	5,697	6,482	7,558	9,794	8,436
(4)	Admitted DTA / Total DTA	31.0%	23.9%	21.4%	21.8%	20.2%	25.6%
(5)	Deferred Tax Liability	63	99	222	97	26	24
(6)	Surplus	45,743	61,074	71,653	79,598	67,447	74,337
(7)	Admitted DTA / Surplus	2.2%	2.2%	1.9%	2.1%	2.9%	2.9%
(8)	Non-Admitted DTA / Surplus	4.9%	7.1%	7.1%	7.4%	11.6%	8.4%
(9)	Total DTA / Surplus	7.1%	9.3%	9.0%	9.5%	14.5%	11.3%

Source: Highline Data from NAIC filings

Deferred Tax Asset Bridge Group Report
September 2010

Appendix 6

Responses to Issues Raised by NAIC Members and Interested Parties

This section addresses comments made by CADTF members and Interested Parties participating in the June 29 and September 9, 2010, conference calls regarding the DTABG's June 1 preliminary report on DTA.

1. A comment was made that the proposal "....takes away the DTA just when the company needs it..." Taking a regulatory perspective, the issue is not whether the company "needs" the DTA to avoid falling into an action level. Rather the issue is whether the company will realize the asset and, therefore, should a regulator depend on that asset. The basis for observations in the report is that a company that is more likely to fail is more likely not to realize the asset and the RBC formula should reflect that. If regulators do not share this view then the portion of the recommendation related to devaluing the DTA for companies in or near an RBC action level can be set aside. For companies not in or near an action level, no DTA-related charge if SSAP 10/10R limitations are retained, or a very small charge if SSAP 10/10R limitations are eliminated, is suggested.

2. It was also observed that the proposal is procyclical which seems somewhat redundant with the prior point (1). As noted in the report, the DTA is a different type of asset than most. It is not independent of the company and, in our view, depends on the company's viability. The proposal is company specific (i.e., it relates to the specific circumstances of a company and not the industry cycle), however it will reduce the benefit of the DTA if the individual company's surplus is adversely affected by an industry cycle and the company is at or near an RBC action level. This will put such companies on the regulator's radar screen not because of the industry cycle but because the company's surplus was not sufficient to carry its business and withstand the cycle without approaching or entering an RBC action level. It will have no impact on the RBC results of a company that is not near an action level.

   Additionally, as noted in the report, current RBC treatment of the DTA implicitly has a similar element of procyclicality to it, albeit somewhat different computationally. As the admitted value of the DTA is largely a function of both current surplus and the ability to earn income, should a company's condition deteriorate, its surplus will decline, as will its ability to earn income. This results in an increasing portion of the DTA being treated as a non-admitted asset, which in turn reduces Adjusted Capital in the RBC calculation. Rather than further reducing Adjusted Capital due to increased non-admission of the DTA (an implicit risk charge), the report discusses an approach that increases the Authorized Control Level via an explicit risk charge.

3. A comment was made that the proposal represents an inappropriate use of RBC results by using the RBC ratio as a measure of the level of the DTA charge, particularly for weak companies. The primary purpose of RBC is to identify weakly capitalized companies that may represent a solvency concern - the same issue we are attempting to identify. While we recognize the restrictions on public use of RBC, we do not believe these restrictions

prevent the NAIC from using interim RBC results to determine further adjustments to the final RBC result. It was concluded that this was practical and efficient and did not depend on information external to the formula (e.g., agency ratings that not all reporting entities have).

4. A comment was made that the report "...states the obvious..." by providing tables that show that the level of the DTA increases as a percentage of surplus as surplus declines and also noting that "...any fixed amount becomes a bigger percentage of a total amount that is declining..."

   The tables serve several purposes. One purpose is to show the specific numbers rather than simply say that DTA is a higher percentage of surplus for companies with declining surplus. They are also intended to give perspective to the number of companies that are in the various "risk" categories and might be affected by the proposal. Additionally, they provide some idea of how much of the DTA is non-admitted currently by "risk" category, illustrating as noted above, that the current RBC calculation implicitly includes a significant capital charge via admissibility rules that increases dramatically as capitalization weakens. The DTAWG believes it would be an omission to exclude this information.

5. A question was raised regarding the threshold of 300% of Authorized Control Level embedded in the original proposal, below which the charge for the DTA begins to increase significantly and whether it should be set more conservatively. The DTAWG originally settled on the 300% ratio primarily because it was consistent with the PC Trend Test, but also because it was viewed as a point where regulators might appropriately begin having concerns about a company's financial condition and dependence on internally driven assets. Data and time constraints limited an analysis of an alternative threshold.

   Additionally, it is important to note that the calculation for the threshold is based on calculating an adjusted RBC, whereby the DTA is removed entirely from Adjusted Capital, as well as any associated charge for the DTA embedded in the calculation of the Authorized Control Level. As such, the original 300% threshold as calculated is more conservative than the 300% level noted in the Trend Test, which implicitly includes the admitted value of the DTA in Adjusted Capital. The original threshold calculation was, however, intended to be consistent with that cited in SSAP10R.

   We revisited this assumption based on feedback received during the comment period on our preliminary report and upon further evaluation of published ratings relative to RBC levels. It should be noted that our review of published ratings identified two issues that made selecting a final recommendation more difficult. First, there was an apparent disconnect between life companies and P&C companies as to what sort of RBC threshold corresponded to a company that would be considered to be in NAIC asset class 1. The RBC threshold appears to be higher for life companies. Second, RBC thresholds for P&C companies tend to be negatively correlated with company size (e.g., highly rated large companies tend to have lower RBC ratios than highly rated small companies). We have not done a detailed analysis of the sources of these disconnects.

Based on this review and further discussions, we revised the formula for the charge to recognize a higher threshold. In the new formula, the charge grades from 200% of ACL to 300% of ACL, and then again from 300% of ACL to 500%. The floor becomes effective at 500% of ACL.

6. A question was posed asking if the amount of DTA charge could be impacted by an RBC charge that is in significant decline. The DTABG looked at the Trend Test. Life companies whose total adjusted capital is between 200% and 250% of ACL are subject to this test. The test calculates the greater of the decrease in the margin between the current year and prior year and the average of the past three years. A company with a negative trend below a certain level would trigger a company action event. For other insurers, the trend test triggers a company action level if the RBC ratio is between 200% and 300% of ACL and the combined ratio is greater than 120% (105% for health insurers).

   The DTABG believes that this Trend Test adequately performs for these weaker companies. For companies above this level, the DTABG believes that declining earnings that precipitate the drop of RBC ratios would cause a valuation allowance adjustment to the DTA that would diminish its carrying value. Thus, the Bridge Group believes that the formula as proposed remains appropriate.