Financial Security. For Life.

Frank Keating
President & Chief Executive Officer

November 11, 2008

Via Email and Overnight Delivery

The Honorable Sandy Praeger
Kansas Insurance Commissioner and President,
National Association of Insurance Commissioners
State of Kansas
Department of Insurance
420 S.W. 9th Street
Topeka, Kansas 66612

Re: Reserve and Capital Relief for Certain Life Insurance Policies and Variable Annuity Contracts

Dear President Praeger:

Thank you once again for the opportunity you and your fellow commissioners gave us last week to discuss the impact of the current market turmoil on the life insurance industry.

As promised, we have developed, and offer for the NAIC's consideration, a list of suggested changes the NAIC can accomplish by year-end 2008 that will provide important near-term relief from conservative reserve and risk-based capital standards. The accompanying talking points provide additional detail regarding the rationale for these suggested changes.

While our initial efforts have focused on changes that could be implemented by year end 2008, we are also looking into other possible steps the NAIC could consider taking next year. We hope to have additional suggestions for your consideration in early 2009 after we complete additional analysis.

We are also grateful that you have chosen to establish a commissioner-level working group to oversee consideration of these suggested changes, given the short timeframe needed for their evaluation. To that end, we would welcome the opportunity for another conference call with your working group, prior to the December NAIC meeting, so that we may respond to any questions the regulators may have. Additionally, the process by which these suggested changes might be implemented by the NAIC and individual states (e.g., approval by an insurer's domiciliary regulator, issuance of a bulletin, etc.) may need to be considered along with the substance of the suggested changes.

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We look forward to working with you, President Praeger, and your colleagues to achieve responsible and prudent reserve and capital relief in a manner that assures consumers are continuing to deal with strongly capitalized companies.

Sincerely,

Frank Keating

cc: The Honorable Roger Sevigny, NAIC President-Elect (NH)
The Honorable Jane Cline, NAIC Vice President (WV)
The Honorable Susan Voss, NAIC Secretary Treasurer (IA)
The Honorable Eric Dinallo (NY)
The Honorable Steve Goldman (NJ)
The Honorable Al Gross (VA)
The Honorable Tom Hampton (DC)
The Honorable Tom Sullivan (CT)
Andy Beal, Acting Executive Director, NAIC

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Financial Security. For Life.

RESERVE AND CAPITAL RELIEF FOR CERTAIN LIFE INSURANCE POLICIES AND VARIABLE ANNUITY CONTRACTS

November 11, 2008

- Our nation's economic turmoil has forced life insurers to find new ways to conserve and attract capital. In the economic environment in which life insurers now do business, investors, rating agencies and consumers alike want to see strong capital levels and a high degree of liquidity.

- In some situations, our current reserving and risk based capital (RBC) systems are simply too conservative, which has the effect of reducing stated capital positions. This works to the detriment of not only insurers, but also to consumers, who are seeking products and product features with meaningful guarantees, especially in today's economic climate.

- For certain products, existing conservative reserving requirements have led life insurers to look to the capital markets for reserve relief in order to provide products to consumers that reflect more appropriate reserve levels.

- With the current market disruptions, however, these capital markets solutions have virtually disappeared or become unavailable to many companies, and this is having an impact on some balance sheets. Impairments on assets have exacerbated this balance sheet impact for many insurers.

- Additionally, the credit crisis has precipitated a rapid decline and unprecedented volatility in the U.S. and international equity markets during the third and fourth quarters of 2008. While it could be expected that this decline would have a material impact on reserves and RBC for variable annuities with guaranteed benefits, the impact of duplicative actuarial requirements may cause excessive reserve and RBC increases not related to the underlying economics.

- Over the next few years, implementation of the NAIC's principles-based reserving initiative – which the ACLI continues to strongly support – should result in the replacement of current, inflexible statutory reserving standards with more appropriate reserve levels that stimulate product innovation, foster competition, and deliver more value to insurance consumers.

- However, PBA for reserves and capital is several years away from being fully implemented. In the meantime, there are important steps that US regulators can take by year-end 2008 that will allow insurers to appropriately and immediately adjust 2008 statutory reserve and RBC requirements to reallocate funds for liquidity and capitalization purposes.

- These steps can and should be taken in a manner consistent with the good work the NAIC has already completed on the PBR project. In fact, these steps would accelerate implementation of certain concepts of PBR, together with moderating some of the formula-based life and annuity RBC requirements that are creating distorted results.

- We have developed the attached list of reserve and RBC changes the NAIC can accomplish in short order, taking effect 12/31/2008. The four categories of changes are those impacting:

    1. life insurance reserves;
    2. annuity reserves and risk-based capital;
    3. risk-based capital for investments; and
    4. accounting for deferred tax assets.

- None of these changes could be considered to "fix" long-standing concerns with the reserve methodologies contained in current regulations and actuarial guidelines, but they do provide some reserve and capital relief and allow regulators to begin to address the problems that exist in the marketplace.

- In making these changes, regulators can provide important near-term relief from conservative reserve and RBC standards, while at the same time assuring consumers that they are dealing with strongly capitalized companies.

- Because these 2008 changes will provide levels of relief that vary by company, and because the ACLI has only looked at changes that could be made very quickly, this list should not be considered to be comprehensive. The ACLI is looking at other possible action the NAIC could consider taking in 2009. We plan to provide more details about these suggestions after we complete additional analysis, an exercise we hope to have completed by early 2009.

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Summary of Ideas and Concepts

Life Insurance

1. Make the "Interim Solution", originally effective 1/1/07, retroactive with consent of the domestic Commissioner

    a. Allow the 2001 Preferred Mortality Tables to be used for any 2001 CSO product
    b. Make Section 8C of Actuarial Guideline 38 retroactive to 7/1/05
    c. Clarify that 2001 Non-preferred Mortality Tables can always be used for determining segments within Actuarial Guideline 38

2. Eliminate artificial constraints in Regulation XXX for the calculation of X factors with consent of domestic Commissioner.

3. Facilitate Commissioner's use of current discretionary authority to exercise judgment to determine allowable US collateral for reinsurance

Variable Annuities

1. Eliminate redundant use of stand-alone asset adequacy analysis required by Actuarial Guideline 39, which covers only Variable Annuity living benefit guarantees and associated revenue under the contract

2. Waive the Standard Scenario as the floor in the C-3 Phase 2 calculation of risk-based capital for year ends 2008 and 2009.

Investments

1. Temporarily fix the calculation of the Mortgage Experience Adjustment Factor in the risk-based capital calculation

Accounting

1. Change Statutory Accounting requirements to follow GAAP rules regarding recognition of the Deferred Tax Asset.

LIFE INSURANCE: Make "Interim Solution" Retroactive

Proposal: Allow the 2001 CSO preferred mortality tables to be used with contracts based on the 2001 CSO and issued prior to January 1, 2007 with domestic Commissioner consent. In addition, encourage adoption of the Model Regulation Permitting the Recognition of Preferred Mortality Tables For Use in Determining Minimum Reserve Liabilities in the remaining states that have not adopted this Model Regulation.

Background: The 2001 CSO preferred mortality tables are currently only available for policies issued in 2007 and later, even though many states approved use of the 2001 CSO table prior to 2007.

Discussion Points:

- The 2001 CSO preferred mortality tables were an element of the CEO compromise, and became effective on 1/1/07. The preferred tables merely split the non-smoker 2001 CSO table into three tables, and the smoker 2001 CSO table into two tables, with the new tables being determined by risk class (preferred or standard). An additional actuarial demonstration is required if the 2001 CSO preferred tables are used, thereby giving additional verification that the use of the preferred tables is appropriate. There is no inherent actuarial reason that the 2001 CSO preferred tables could not be used for business issued on a 2001 CSO basis prior to 1/1/07.
- For companies with captive reinsurance arrangements, this reserve reduction would reduce the amount of LOCs or other assets needed in the reinsurance trusts to secure reinsurance reserve credits. In the current economic environment, it is proving very difficult to secure new LOCs or increase existing LOCs or enter into new securitization arrangements.
- The reserve relief provided by this proposal would be on inforce policies, but it might allow companies to continue issuing/ceding new policies using existing arrangements by making some of the financing already established for these inforce policies available for new policies.

Action: **Amend NAIC Model 815 and NAIC APPM Appendix A-815, Model Regulation Permitting the Recognition of Preferred Mortality Tables for use in Determining Minimum Reserve Liabilities, so that Commissioners may permit an effective date earlier than January 1, 2007, as early as the date that 2001 CSO is effective in their state. Amend Actuarial Guideline XLII to reflect the revised issue dates applicable to the 2001 CSO Preferred tables.**

LIFE INSURANCE: Make "Interim Solution" Retroactive

Proposal: Allow Actuarial Guideline XXXVIII (AG 38) section 8C to be effective for policies and certificates issued 7/1/05 to 12/31/06 which are currently covered under section 8B, with domestic Commissioner consent.

Background: Currently AG 38 Section 8B is effective for policies and certificates issued on or after July 1, 2005 and on or prior to December 31, 2006, and it will be effective for policies and certificates issued on or after January 1, 2011. The reserves required under AG 38 Section 8B are greater than those required under Section 8C, which is effective for policies issued in 2007-2010.

Discussion Points:

- As part of the CEO compromise, AG 38 section 8C was given a future starting date and not made retroactive for competitive reasons. At that time, it was desirable to avoid an uneven playing field for policies/products marketed and issued while the compromise was being negotiated. This is no longer a concern as all products currently being marketed and issued are subject to the reserving requirements of AG 38 section 8C.
- This proposal would reduce the required AG 38 reserves for policies issued from July 1, 2005 through December 31, 2006 to the level required for polices issued currently.
- For companies with captive reinsurance arrangements, this reserve reduction would reduce the amount of LOCs or other assets needed in the reinsurance trusts to secure reinsurance reserve credits. In the current economic environment, it is proving very difficult to secure new LOCs or increase existing LOCs or enter into new securitization arrangements.
- The reserve relief provided by this proposal would be on inforce policies, but it might allow companies to continue issuing/ceding new policies using existing arrangements by making some of the financing already established for these inforce policies available for new policies.
- All policies with reserves calculated in accordance with AG 38 section 8C are subject to a standalone asset adequacy analysis. This proposal would increase the number of policies subject to that standalone asset adequacy analysis, thereby giving additional verification that the use of AG38 section 8C is appropriate.

Action: **Amend Actuarial Guideline 38 to allow section 8C to be effective for policies issued on or after July 1, 2005 with domestic Commissioner consent.**

LIFE INSURANCE: "Interim Solution" Technical Clarification

Proposal: Clarify by means of an Actuarial Guideline that when using the Preferred Structure Tables of the 2001 CSO for basic reserves, the original smoker or non smoker tables respectively may be used for determining segments when complying with the Valuation of Life Insurance Policies Model Regulation.

Background: This would permit products designed under the Nonsmoker/Smoker versions of the 2001 CSO table for contract segmentation purposes to use the super preferred, preferred and residual forms of the 2001 CSO Preferred Class Tables.

The Valuation of Life Insurance Policies Model Regulation was adopted under a 1980 CSO minimum valuation standard. Since that table did not contain the preferred mortality rates, the issue of which set of mortality rates to use for segmentation was not clearly addressed. Since that time, the 2001 CSO tables were adopted as the minimum valuation standards for reserve standards and in 2006, the Model Regulation Permitting the Recognition of Preferred Mortality Tables For Use in Determining Minimum Reserve Liabilities was adopted that defined the 2001 CSO Preferred Class Structure Mortality Table. The technical application of the requirements could create a situation in which different underwriting classes could have different product designs in order to efficiently comply with reserve requirements.

The preferred mortality model regulation also made it clear that the 2001 CSO Preferred Class Structure Mortality includes the smoker and nonsmoker versions of the 2001 CSO table as well as the preferred and residual versions.

The Valuation of Life Insurance Policies Model Regulation for purposes of the contract segmentation method requires the use of the valuation mortality rates for deficiency reserves. The contract segmentation method is a bright line test and as such, many products are designed to comply with this test while optimizing product design. Determining segments is heavily dependent on the slope of the mortality rates from year to year. Given the bright line nature of the test and the sensitivity of segmentation to the slope of the mortality curves, companies would like to be confident to determine segmentation using the 2001 nonsmoker smoker versions of the table as well as benefit from the use of the preferred mortality table as appropriate to determine basic reserves.

The regulations do not appear to prohibit the use of separate versions of the table for contract segmentation methods and for basic reserves; however, they also do not clearly make this permissible. Making this explicitly permissible is desirable and does not appear inconsistent with past practices to use separate versions of CSO tables for deficiency reserves from those used for basic reserves.

Action: **Approve an Actuarial Guideline as referenced above.**

LIFE INSURANCE: Deficiency Reserves

Proposal: Remove the artificial X factor restrictions (i.e. 20% floor and non-decreasing requirements) from the deficiency reserve calculation required by the NAIC Valuation of Life Insurance Policies Model Regulation.

Background: The NAIC Valuation of Life Insurance Policies Model Regulation, contained in Appendix A-830 of the NAIC Accounting Practices and Procedures Manual ("Reg XXX"), establishes the methodology for calculating deficiency reserves on business subject to the regulation.

- For the purpose of calculating the deficiency reserve, Reg XXX recognizes the conservative nature of valuation mortality and allows companies to adjust valuation mortality toward their experience via the use of an X factor, which is applied to the valuation mortality (¶17).
- The calculation of the X factor is limited in ¶17.c.ii:
  - "X shall not be less than twenty percent (20%)"
- The calculation of the X factor is further limited in ¶17.c.iii:
  - "X shall not decrease in any successive policy years"
- The valuation actuary can modify the X factors applicable to all business subject to the regulation as appropriate (¶17.c.vii and viii)

Discussion Points

- The 20% floor is an arbitrary limit that restricts X factors applicable to some super preferred classes of business.
- The non-decreasing requirement is also an arbitrary limit that significantly restricts the x-factors:
  - Actual mortality factors typically decrease between policy years 3 and 4 due to a post-incontestability claim spike in policy year 3.
  - Actual mortality on highly preferred classes has almost no slope for 10-20 years, but valuation mortality exhibits a steep slope.
- The use of X factors in the calculation of the deficiency reserve is consistent with the concept of principle-based reserves; however, arbitrary limits on the X factor calculation are not consistent with the concept of principle-based reserves.
- For companies with captive reinsurance arrangements, this reserve reduction would reduce the amount of LOCs or other assets needed in the reinsurance trusts to secure reinsurance reserve credits. In the current economic environment, it is proving very difficult to secure new LOCs or increase existing LOCs or enter into new securitization arrangements.
- The reserve relief provided by this proposal would be both on inforce policies and new policies. It might allow companies to continue issuing/ceding new policies using existing arrangements by making some of the financing already established for these inforce policies available for new policies.

- Removing the artificial restrictions will provide a significant benefit to new business, particularly in the first few policy years, and, due to the unlocking nature of X factors, will also facilitate the release of redundant deficiency reserves on existing business.

Action: **Amend A-830 by deleting ¶17.c.ii and modifying ¶17.c.iii to read "X may decrease in successive policy years in which expected experience decreases or increases less than the mortality rate to which X is applied".**

<u>REINSURANCE: Commissioner Discretionary Authority on Collateral</u>

Proposal: Facilitate Commissioners' use of their existing discretionary authority under the Model Law and Regulation on Credit for Reinsurance to provide immediate relief to ceding insurers.

Background:

- <u>Situation</u>—US ceding insurers are experiencing temporary difficulties in reserve financing, for two reasons—letters of credit (LOCs) capacity is severely limited and the market value of trusteed assets has declined significantly.
  - US ceding insurers can take statutory reserve credit for their cessions to insurers not licensed or accredited in the US <u>only to the extent</u> that the cession is secured by collateral that qualifies under the Model Law and Regulation on Credit for Reinsurance. Typically that collateral is either a LOC or a trust funded with assets acceptable under the same Law and Rule.
  - Banks typically re-price LOCs annually. The current credit crisis is pressuring bank capacity to issue LOCs, which is limiting their availability markedly.
  - The market value of assets in trusts securing reinsurance cessions has dropped substantially in the fourth quarter. Ceding insurers using a trust as collateral must—before the end of 2008—either "top-up" the trust or reduce their reserve credit to the level of the market value of the assets.
- <u>Relevant law/rules</u>
  - Section 3 of the Law and Section 9 of the Regulation say that a ceding insurer can take reserve credit for cessions to unauthorized insurers—
    - "in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the ceding insurer." This phrase limits a ceding insurer's reserve credit to the amount of the LOC or the market value of the trust securing that cession.
    - If the security is—
      - cash;
      - securities listed by the NAIC SVO qualifying as admitted assets;
      - letters of credit meeting standards specified in the Model Regulation, including that the LOC be "issued or confirmed by a qualified US financial institution"; or
      - "any other form of security acceptable to the commissioner."
  - Section 4 of the Law defines a "qualified US financial institution" as one -
    - Organized or licensed in US;
    - "[R]egulated, supervised and examined by US federal or state authorities having regulatory authority over banks and trust companies;" and
    - Either the Commissioner or the SVO determines that the issuing or confirming institution meets "such standards of financial condition and standing as are considered necessary and appropriate to regulate the quality of financial institutions whose letters of credit will be acceptable to the Commissioner."
  - Section 2.B. of the Law defines an "accredited reinsurer" as one that -

- Evidences its submission to the state's jurisdiction and submits to state's authority to examine its book and records;
- Is licensed or branched into at least one state;
- Files with commissioner its annual statement and its most recent audited financial statement; and
- Has surplus of at least USD 20 million.

Discussion:

1. The Commissioners' authority in existing law and regulation, as described above, could be applied immediately, under Section 3 and 4 of the Law and Section 9 of the Regulation, to expand available collateral—
   - Accept LOCs issued by the Federal Reserve or issued by US banks and confirmed by the Federal Reserve;
   - Accept funds provided by the Federal Reserve in US trusts;
   - Accept LOCs issued by non-bank US institutions (such as Microsoft or an insurance holding company); and/or
   - Expand the interpretation of the phrase "any other form of security acceptable to the commissioner" (such as assets not owned by the reinsurer in a complying US trust, or such as a guarantee of reinsurance payments by a US parent or affiliate).
2. The Commissioners' authority in existing law and regulation, as described above, could be used to establish criteria for expediting accreditation of assuming insurers before year-end 2008 under Section 2.B of the Model Law.

Action: **The NAIC should issue guidance to commissioners (e.g. via resolution) on the methods of exercising their current authority under the existing Model Law and Regulation on Credit for Reinsurance to ease and widen access to reserve financing. The NAIC should disseminate said criteria to all states in order to facilitate the greatest degree of uniformity.**

Variable Annuity: Reserves

Proposal: Eliminate the standalone asset adequacy analysis requirements in Actuarial Guideline XXXIX – Reserves for Variable Annuities with Guaranteed Living Benefits (AG 39).

Background: Section III.C. of AG 39, states the following ("VAGLB" is defined as guaranteed living benefits available under variable annuity contracts):

C. Asset Adequacy Analysis Requirement

The appointed actuary must perform a standalone asset adequacy analysis of the VAGLB reserve. If such analysis reveals a reserve shortfall, VAGLB reserves must be increased. Such analysis shall be performed reflecting the following:

1. *all VAGLB benefits and expenses,*
2. *all VAGLB charges, and*
3. *the assets supporting the VAGLB reserves.*

The analysis shall be performed on an aggregate basis for all contracts with VAGLBs, consistent with the requirements of the NAIC Model Actuarial Opinion and Memorandum Regulation, including the requirement that the analysis conform to the Actuarial Standards of Practice as promulgated from time to time by the Actuarial Standards Board. However, no separate actuarial opinion is required by this Actuarial Guideline.

Where the VAGLB is reinsured, the asset adequacy analysis may reflect the reinsurance. However, if the inclusion of reinsurance in the asset adequacy analysis would increase the VAGLB reserve, then reinsurance must be reflected in the analysis.

Discussion Points

- The standalone asset adequacy analysis under AG 39 focuses only on VAGLB charges, thereby ignoring additional fees and revenue that are available under the contract in situations where the living benefits are elected. This increases the potential that results will not reflect the true risk position of the company and that the true liability will be overstated.
- Under current economic conditions, the limitation of the revenue used in the analysis can have a particularly severe effect on the results.
- Suspending the AG 39 analysis requirement will not mean the adequacy of variable annuity reserves will be ignored because there is a standalone asset adequacy analysis required by Actuarial Guideline 34 (AG 34), which applies to the total reserves for variable annuities.
- The AG 34 standalone analysis requirement was added in 2004, two years after the standalone analysis in AG 39 was put into place. So the standalone analysis in AG 39 is redundant.
- AG 39 is scheduled to be repealed in 2009 (the repeal was part of the adoption of Actuarial Guideline VACARVM). Removing the standalone asset adequacy analysis requirement in AG 39 is comparable to suspending it for year-end 2008 and the first

three quarters of 2009. Note that the standalone asset adequacy analysis required by AG 34 will still be in place until the fourth quarter of 2009.

Action: **Amend Actuarial Guideline 39 to remove section III.C.**

Variable Annuity: Risk-Based Capital (RBC)

Proposal: Modify C-3 Phase II for year-ends 2008 and 2009 to waive the Standard Scenario.

Background: The risk-based capital (RBC) requirements for variable annuities, C-3 Phase II, are contained in LR025 – Interest Rate Risk and Market Risk in the 2008 RBC Instructions.

Discussion Points

- The Standard Scenario's use of a single deterministic scenario and a single set of assumptions to quantify risk on products with embedded guarantees results in an inaccurate assessment of the risks compared to the CTE calculation.
  - For example, revenue and policyholder behavior assumptions are prescribed in a "one size fits all manner." Such assumptions may be highly conservative for many product designs.
  - Additionally, the Standard Scenario allows no credit for future dynamic hedging actions. Even during the recent tumultuous market, dynamic hedging programs have continued to function. Thus, the approach used under the Standard Scenario is highly conservative. This is an unrealistic assumption and has punitive effects.
- In a situation where the application of the Standard Scenario understates the required capital, the CTE calculation is used to determine the required capital.
- The result is a potential overstatement of required capital.
- The current economic environment substantially increases the potential for overstatement of required capital.

Action: Add the following paragraph to LR025 of the 2008 and 2009 RBC Instructions, under <u>Calculation of the Total Asset Requirement</u>, as new item I:

I. For the (2008) (2009) RBC calculation, the Standard Scenario Amount shall be set to zero, and the Standard Scenario shall be calculated for informational purposes and shall be made available to the commissioner upon request.

INVESTMENTS: Risk Based Capital for MEAF

Proposal: Temporarily modify the calculation of the Life RBC Mortgage Experience Adjustment Factor (MEAF) as outlined below.

Background: Commercial mortgages are not publicly rated. The NAIC implemented the MEAF in the RBC calculation to recognize the difference in risk between the mortgage portfolios of different companies. The MEAF is calculated by dividing a company's default experience by the average default experience of all life insurers, each using a rolling 8 quarter average. The MEAF has a floor of 50% and a ceiling of 350%, and, when multiplied by the standard RBC factor for "mortgages in good standing" of 2.6%, gives a company RBC factor that ranges from 1.3% to 9.1%.

Life insurer's default experience on commercial mortgage loans has materially improved over the past decade. For 2007, the Industry Normalized Loss Ratio was 0.004%, and the Loss Ratio is expected to be 0.002% for 2008. Such low default rates have caused the denominator of the MEAF calculation to approach zero.

A MEAF denominator of near zero causes volatile RBC charges for individual companies. Companies have computed that their RBC requirements can increase by $10 for every $1 in face amount of impaired mortgages.

Discussion Points:

- The MEAF was introduced into the RBC formula to adjust for the quality of each company's commercial mortgages by comparing each company to the industry average. The MEAF is not accomplishing that intended goal in today's environment of negligible problem loan activity.
- Very small increases (and, in some cases, decreases) in company default ratios have resulted in significant RBC increases, even in the face of excellent overall commercial mortgage default experience..
- The ACLI has developed a proposal for modifying MEAF which would floor the denominator of the calculation at the level of roughly one-half of the industry average default experience over the past 20 years. This change would have the beneficial effect of reducing the volatility of the calculation at times when industry default experience is very favorable. The MEAF will still provide for increased RBC charges for companies whose mortgage portfolios have worse default experience than the industry, subject to the denominator floor.
- Actual industry experience on commercial mortgages for the past 10 years has been excellent as evidenced by the extremely low Industry Normalized Loss Ratio. The ACLI proposal would require a company whose mortgage experience is at industry average, which is currently approximately equivalent to AAA bond experience, to hold RBC equivalent to the capital for a BBB bond. Higher amounts of RBC would still be required of any company whose mortgage experience was worse about an A equivalent.
- This proposal is intended to be temporary, until such time as a new basis for RBC for commercial mortgages can be developed. The ACLI has committed to work with the NAIC to develop a revised method to determine RBC for commercial mortgages.

- If industry experience were to deteriorate prior to the development of a new basis for RBC for commercial mortgages, the calculation of RBC would automatically continue to use the current system.
- The ACLI discussed the problems with the current MEAF calculation with the Life RBC Working Group in August 2008, and the Working Group seemed to agree that the current MEAF calculation is not working as originally intended. The ACLI also presented its proposal for modifying the MEAF calculation, but the proposal was rejected by the Working Group on the basis that it would cause a decrease in current RBC requirements for the industry. The industry believes that a decrease in current RBC requirements is appropriate, given the very favorable industry experience on commercial mortgages, and believes that the current operation of the MEAF is producing results that were never intended when the formula was designed.

Action: **Amend the RBC instructions for LR003 line 12 for commercial mortgages that are "in good standing" to use a denominator equal to the greater of the calculated Industry Normalized Loss Ratio (per current RBC instructions) or 0.075%. For 2008, direct the NAIC staff to publish the larger of the computed value or 0.075% as being the Industry Normalized Loss Ratio.**

ACCOUNTING: Admissibility of Deferred Tax Assets

Proposal: Replace the current limits on the admissibility of deferred tax assets (DTA's) under SSAP 10 with a valuation allowance approach similar to US GAAP.

Background: Statutory accounting rules have placed limitations on the amount of a deferred tax asset that may be recognized for statutory purposes. In light of unprecedented declines in equity and fixed income investment valuations the current constraints on the admissibility of DTA's are unnecessarily amplifying the adverse economic effect on insurers.

Currently, gross DTA's are 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 DTA's, 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; and
3. The amount of gross DTA's, after application of paragraphs 1 and 2, that can be offset against existing gross deferred tax liabilities (DTL's).

US GAAP (SFAS 109) provides that DTA's must be reduced by a valuation allowance if it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the DTA's will not be realized. The valuation allowance should be sufficient to reduce the DTA's to the amount that is more likely than not to be realized.

Discussion Points:

- Generally, if the surplus limitation in 2(ii) above does not come into play, SSAP 10 allows recognition of net DTA's (that is, gross DTA's net of DTL's) in an amount equal to DTA's that reverse by the end of the subsequent calendar year.
- Equity market declines and investment write downs under current economic conditions, coupled with statutory reserving and the expensing of acquisition costs, are giving rise to growing amounts of DTA's which in many cases will be realized more than one year in the future. Utilization of the SSAP 10 formulaic approach for admitting an insurance company's DTA's is far more conservative than the approach to DTA recognition used in US GAAP or International Financial Reporting Standards (IFRS).
- The SSAP 10 approach employs an unrealistically short time period for which an insurance company is "allowed" to utilize a DTA (i.e., realized within one year of the balance sheet date) for determining admissibility.
- As is the case with SFAS 109, the time period over which an insurance company can realize a DTA for a tax loss or credit carryfoward should be consistent with the federal tax law and not be an unrealistically short period which has no basis under the tax law.

- Aligning DTA admissibility with US GAAP standards provides the industry with the ability to recognize the tax benefit of DTA's that are more likely than not to be realized while still requiring a reserve threshold that meets the principles of statutory accounting.

Action: **Replace the current limits on the admissibility of deferred tax assets (DTA's) under SSAP 10 with a valuation allowance approach similar to US GAAP. For 2008, increase the period over which the benefits are projected to be realized to five years and increase the limit as a percent of statutory capital and surplus to 25%.**