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ACLI'S CAPITAL & RESERVE RELIEF PROPOSALS

In late 2008, in the midst of what has been described as "an unprecedented time of economic upheaval,"[1] the American Council of Life Insurers (ACLI) made several proposals to the National Association of Insurance Commissioners (NAIC) to provide life insurers the necessary capital flexibility to operate in a highly volatile economic climate. These proposals, many of which have been under consideration by insurance regulators for several years and were expected to be adopted in 2009, related to four categories: (1) life insurance reserves; (2) annuity reserves and risk-based capital; (3) risk-based capital for investments; and (4) accounting for Deferred Tax Assets (DTAs). ACLI had urged NAIC to adopt these proposals in time for them to apply to life insurance companies' year-end 2008 financial reports.

ACLI's proposals, if implemented, would have freed up approximately $25-30 billion in capital that is now trapped due to outdated reserving, accounting and investment standards that ultimately impact risk-based capital requirements. In the current economic environment, these conservative methodologies may actually cause undue stress to the very companies whose financial integrity they were intended to assure. The capital provided through implementation of ACLI's suggested changes was estimated to be 6-7 percent of the industry's total adjusted capital reported for 2007.

NAIC CONSIDERATION OF ACLI'S PROPOSALS

In response to ACLI's request, NAIC created the Capital and Surplus Relief Working Group to review these proposals with the aid of several NAIC technical groups. In December 2008, these technical groups approved six of ACLI's nine proposals, in some cases with modifications that would have reduced the amount of relief afforded by approximately one-half.[2] On Jan. 27, 2009, the NAIC Working Group adopted these recommendations from the technical groups.[3] As has been widely reported, on Jan. 29, 2009, NAIC's Executive Committee and Plenary ultimately rejected expedited action on all these proposals.[4]

DTA PROPOSAL

While ACLI views all these proposals as important, the proposal to modify the accounting for DTAs has the largest potential impact for the life insurance industry. DTAs represent amounts that an insurance company may be able to use to offset future tax liabilities if the insurer ultimately earns a profit in that future period. While the technical nature of the DTA has been discussed previously in an earlier edition of this publication,[5] this update column focuses on the ACLI's DTA proposal and the NAIC's subsequent modifications.

Statutory accounting rules have placed conservative limitations on the amount of a DTA that companies may recognize. In light of the recent unprecedented declines in equity and fixed income investment valuations, the current constraints on the admissibility of DTAs are unnecessarily amplifying the adverse economic effect on insurers. Consequently, ACLI requested that NAIC consider revising the NAIC Statement of Statutory Accounting Principles No. 10—*Income Taxes* (SSAP 10) for realization of DTAs due to the economic crisis and its impact on insurer's surplus.[6]

Currently, SSAP 10 admits gross DTAs in an amount equal to the sum of:

1. Federal income taxes paid in prior years that can be recovered through loss carrybacks 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. 10 percent of statutory capital and surplus; and
3. The amount of gross DTAs, after application of paragraphs 1 and 2, that can be offset against existing gross deferred tax liabilities (DTLs).[7]

These DTA calculation components provide a conservative limitation by restricting the DTA's realization period to one year and capping this component amount at 10 percent of adjusted capital and surplus.[8] Generally, if the surplus limitation does not come into play, SSAP 10 allows recognition of net DTAs (gross DTAs net of DTLs) in an amount equal to DTAs that reverse by the end of the subsequent calendar year. This approach employs an unrealistically short time period for allowing an insurance company to utilize a DTA for determining admissibility. 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 DTAs that companies often will realize more than one year in the future. Utilization of the SSAP 10 formulaic approach for admitting an insurance company's DTAs is far more conservative than the approach to DTA recognition used in US GAAP (SFAS 109) or International Financial Reporting Standards (IFRS).

US GAAP allows full recognition of the entire DTA, but sets up a valuation allowance (or reserve) for any DTA that has a likelihood of 50 percent or better that some portion or all of the DTA will not be realized.[9] The valuation allowance should be sufficient to reduce the DTAs to the amount that is more likely than not to be realized.[10] Aligning DTA admissibility with US GAAP standards provides the industry with the ability to recognize the tax benefit of DTAs that are more likely than not to be realized, while still requiring a reserve threshold that meets the principles of statutory accounting.

ACLI believes that 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 that has no basis under the tax law. Specifically, ACLI requested that NAIC: (1) for 2008, increase the period over which the benefits are projected to be realized from one year to five years and increase the limit as a percent of statutory capital and surplus from 10 percent to 25 percent; and (2) replace the current limits on the admissibility of DTAs under SSAP 10 with a valuation allowance approach similar to US GAAP.[11]

Because of the interdependency between SSAP 10 paragraphs 10a and 10b relating to the reversal of existing temporary differences, ACLI requested that the limits of both 10a and 10b change concurrently, as these two sections were drafted to work in an interdependent manner in the existing version of SSAP 10. These changes included changes to paragraphs 10a, 11a, and 11d.[12] Current paragraph 10a allows admission of gross DTAs to the extent that taxes paid in the carryback period could be recovered by the reversal of those existing temporary differences within the next year.[13] Current paragraph 10b allows admission of gross DTAs in the amount expected to be realized from the reversal of existing temporary differences in the subsequent calendar year, less the amount of gross DTAs admitted under paragraph 10a, but not in excess of 10 percent of adjusted capital and surplus.[14] Determining the realizability of DTAs over a future period also requires the determination of the reversing temporary differences over that same period.[15] To properly preserve this relationship, modification of paragraph 10b(i) requires a similar modification to paragraph 10a to account for reversals of existing temporary differences within the following three years.

NAIC DTA MODIFICATIONS

Based on a recommendation from the NAIC Statutory Accounting Principles Working Group in December 2008, the NAIC Capital and Surplus Relief Working Group recommended increasing the realization limitation period from one year to three years, and revising the percentage of capital surplus limitation from 10 percent of capital and surplus to 15 percent of capital and surplus.[16] The Working Group also recommended that the Statutory Accounting Principles Working Group revisit this issue after the 2009 reporting period to determine if these reduced limitations remain appropriate.[17]

To address concerns about losing regulatory authority over companies that would be subject to any type of regulatory control based on their level of risk-based capital, the Capital and Surplus Relief Working Group further modified the proposal to prohibit the additional increase

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generated by the revised DTA limitations counted in: (1) determining capital or surplus for RBC purposes if the company is below the trend test line; (2) determining the extraordinary dividend threshold; (3) holding company filing triggers; (4) calculation of investment limitations, including the basket clause; (5) liquidation and rehabilitation triggers; and (6) any other regulatory processes and procedures that utilize admitted assets or statutory surplus.[18] The Working Group also included a requirement that insurers separately report the amount of assets or surplus admitted under the increased thresholds by specifically reporting the items as a write-in to where the impact can be transparent to users of the financial statements.[19]

FURTHER CONSIDERATIONS

Because NAIC declined to act, the resulting lack of uniform guidance on how to respond to rapidly changing and volatile economic conditions leaves the responsibility for addressing these concerns to the individual states. Several states have already granted relief to individual domestic companies to implement some of the relief ACLI requested.[20] Additionally, NAIC continues to consider some of the proposals through the NAIC's standard process of debate in technical groups and committees. ACLI expects that the NAIC Statutory Accounting Principles Working Group will continue to review the DTA proposal, so ACLI will continue to work with NAIC and individual states to help them understand how the DTA and other proposals will: (1) provide insurance life companies with a financial cushion and operational flexibility; (2) provide the public with more accurate information on the industry's ability to withstand any further potential downturn in the economy; and (3) give consumers what they need to make informed decisions about their financial futures.

END NOTES

1. *See* Press Release, NAIC, *Capital, Surplus Relief Measures Receive Open, Expeditious Review* (Jan. 5, 2009), at *http://www.naic.org/Releases/2009_docs/capital_surplus_review.htm.*
2. *See* Capital & Surplus Relief Working Group Grid of Information Relative to Each ACLI Request, at *http://www.naic.org/documents/committees_ex_capital_surplus_relief_wg_consensus_rec_grid.pdf.*
3. *See* Press Release, NAIC, *NAIC Holds Hearing to Discuss Capital and Surplus Changes* (Jan. 27, 2009), at *http://www.naic.org/Releases/2009_docs/capital_surplus_hearing.htm.*
4. *See* Press Release, NAIC, *Regulators Deny Industry's Request To Lower Capital, Surplus Standards* (Jan. 29, 2009), at *http://www.naic.org/Releases/2009_docs/capital_surplus_denied.htm.*
5. *See, e.g.*, Edward L. Robbins, "Calculation of Tax Expense in a Principles-Based Reserve Environment," *TAXING TIMES*, Feb. 2008, at 24.
6. *See* letter from Frank Keating (ACLI) to Sandy Praeger (NAIC) (Nov. 11, 2008), at *http://www.naic.org/documents/committees_ex_capital_surplus_relief_acli_proposal.pdf.*
7. *See* NAIC Statement of Statutory Accounting Principles No. 10—*Income Taxes* (SSAP 10), para. 10.b.i (1-year restriction of realization period) and para. 10.b.ii (10% limitation of adjusted capital and surplus).
8. *Id.*
9. Statement of Financial Accounting Standards No. 109 (FAS 109) (Feb. 1992), at *http://fasb.org/pdf/fas109.pdf.*
10. *Id.*
11. *See* Keating letter, supra note 6.
12. *See* Bruce Ferguson & Paul Graham letter to NAIC's Capital and Surplus Relief Working Group (Jan. 23, 2009), at *http://www.naic.org/documents/committees_ex_capital_surplus_relief_exposure_comments_acli.pdf.*
13. *See* SSAP 10, supra note 7.
14. *Id.*
15. *Id.*
16. *See* Report from Thomas Hampton, Chair, Capital and Surplus Relief (EX) Working Group to NAIC Executive Committee, Jan. 28, 2009, at *http://www.naic.org/committees_e_capital_surplus_relief.htm.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *See, e.g.*, Iowa State Insurance Bulletin 09-01, Feb. 3, 2009, at *http://www.iid.state.ia.us/docs/bull0901.pdf* (permitting domicile companies to use higher limitations to determine the admitted amount of DTAs).