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NAIC Statutory Reporting Codification

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Summary: Late in 1999, the National Association of Insurance Commissioners (NAIC) adopted Codification of Statutory Accounting Principles. With a targeted uniform compliance date of January 1, 2001, insurers need to focus their attention on the implementation impacts associated with codification.

The instructors give a brief introduction to codification. They also walk through the impacts that codification might have on the company. These impacts include:

- *Changes in accounting treatment and their impact on surplus and risk-based capital.*
- *Required changes in operational policies and procedures.*
- *Changes in the annual and quarterly statement reporting process.*

MR. JAMES F. REISKTYL: Ted Schlude and I will be presenting an overview of the results described in detail in a booklet that is hundreds of pages in length.

MR. RAYMOND T. SCHLUDE: It is actually two books now.

MR. REISKTYL: This overview will give you some feel for the changes. Ted will focus on the changes in actuarial reserves and liabilities and the transitions to the new basis. Then I will focus on the codification impact on the asset valuation reserve (AVR), the interest maintenance reserve (IMR), life risk-based capital (RBC), and some recent developments. We should have ample time at the end to address your specific questions.

I've already had a few specific questions involving possible state variations. We will be talking about the NAIC standards, and if the state adopts some other requirements that are not consistent with NAIC standards, you have to comply with state law and then you must disclose the differences from codification. A more interesting question might be, are the state interpretations consistent with NAIC codification and, therefore, acceptable.

Ted is from M&R in Chicago. He specializes in financial reporting. He and I have been going to NAIC meetings together for eight or ten years, so he is an expert in this area.

I work for Northwestern Mutual in tax and financial reporting with an emphasis on tax. I also chair the interested persons of the AVR/IMR group, and I'm an active member of the Life RBC Task Force. So with that background, I'll turn it over to Ted to give you a basic description of the changes to actuarial reserves and liabilities.

MR. SCHLUDE: NAIC codification is a project that took about five years. The definition of codification in the *Accounting Practices and Procedures Manual* is a comprehensive guide to statutory accounting principles, composed of the preamble, the statements of statutory accounting principles (SSAPs), and the appendices. For about the last two years, the NAIC has been holding three-day seminars focused on codification. As Jim indicated, we're going to try to cover it, but an hour-and-a-half isn't a lot of time to cover a two-inch-thick manual.

In terms of the development and the history behind codification, everyone is aware that the historical state audit standard was prescribed or it permitted practices. The NAIC's principles allowed, in many instances, choices of accounting and/or reserving methods. These two factors created concern within the public accounting profession as to how to opine on a company when there's all this variance in terms of guidance.

The concern of state regulators focused on some of the financial problems they were seeing with companies, and they began to wonder about the variability of different financial statement presentations that they were seeing. At the same time, RBC was being developed, and these

were thought to be tools that were going to be more meaningful for regulators. If they have RBC and the accounting standards of various states differ, it makes RBC a questionable tool. So their idea was let's get statements as consistent as possible so we can use RBC across the board. Codification in that respect was the ideal solution.

In terms of implementation, the practical solution was that the NAIC went ahead and developed codification and adopted codification at the NAIC March 1998 meeting. I think there was maybe one standard that was adopted a quarter later and that was a standard with respect to health care entities. So by June 1998, they had this codified manual, which they renamed the *Accounting Practices and Procedures Manual*. It became effective January 1, 2001. In order to get everyone to buy into codification, they retained the state audit standards. It still allows the state to prescribe or permit accounting and, for that matter, reserving practices as they see fit.

In terms of implementation of the accounting manual itself, I think many states just have references in their code to the *Accounting Practices and Procedures Manual*. When the Codification Working Group renamed it from *Codification* to the new *Accounting Practices and Procedures Manual* it, in essence, became effective in many states. I believe those states feel that what they're doing is issuing a bulletin and just making companies aware that this new standard will be applicable January 1, 2001. Other states incorporate aspects of accounting practices and procedures directly into their laws, and I believe they have a more difficult process of implementation. While they embraced prescribed or permitted practices to reach this compromise, a disclosure note was created. Any material differences in the income and statutory surplus for a company, following its state's prescribed or permitted practices, would be disclosed in the footnotes to the financial statement.

I had already indicated the effective date is January 1, 2001, and any one time changes in the balance sheet will run through the capital and surplus account in the first quarter of 2001. All states will most likely or have already adopted codification in one form or another. I believe the State of New York is still studying codification. I think it embraces the concept, but is just making sure that it doesn't conflict with any of its regulations and laws. There's a delayed process between the time something adopted by the NAIC becomes an accreditation standard

and, I believe, the date that they anticipate the new *Accounting Practices and Procedures Manual* will become effective as an accreditation standard, which is January 1, 2004.

In terms of the use of codification, the NAIC continues to allow state prescribed and permitted practices. From the AICPA Insurance Company's Committee, it's not necessary for the Auditing Standards Board to grant codification status as an Other Comprehensive Basis of Accounting because it will not be the sole accounting basis. I believe they're saying the auditors will still be permitted to continue to provide audit opinions based on prescribed and permitted practices of the state of domicile. Again, the key is disclosure in the footnotes to the financial statements.

With respect to the structure of codification, there are various aspects of the newly released accounting manual. There have actually been two releases of the codified manual now. One is a 1999 version and now the 2000 version consists of two volumes. The preamble just defines statutory accounting practices or principles, generally, and defines the statutory hierarchy. The Statements of Statutory Accounting Principles (SSAPs) provide the real guidance, accounting guidance, and various appendices.

Appendix A provides specific guidance on disclosure, reserving and, for that matter, it includes specific model laws and regulations which we'll get into later. Basically, any model law or regulation that deals with reserving is, in part, included in codification. Definitions and the reserving guidance of the models have been incorporated into this appendix and will continue to be incorporated into this appendix as new models are adopted by the NAIC. There is a new appendix, Appendix B, which includes 29 technical interpretations of the Emerging Accounting Issues Working Group. Those 29 interpretations are ones that emerged between the release of the 1999 version and the 2000 version of the accounting manual.

A new addition to the 2000 version of the manual is incorporation of the Actuarial Guidelines in Appendix C. In codification, the Actuarial Guidelines are referenced in various SSAPs. At a 1999 meeting, the Accounting Practices and Principles Task Force incorporated the Actuarial Guidelines into the codification manual. It was pointed out that they already exist in the *Examiner's Handbook*, and I think the Task Force said that's fine. The examiners can keep them

in their handbook, but we are putting them in here. I believe they appear in both places at this point.

Appendix D provides a useful GAAP cross-reference to the SSAPs. Appendix E provides issue papers and these papers provide more detail, in many cases, with respect to issues that were contemplated and, ultimately, the decisions made in the SSAPs themselves. If the issue papers are contradictory to the SSAPs, the preamble says that the SSAPs, obviously, govern the accounting practices. Appendix F just defines how the NAIC plans to maintain codification prospectively and react to new GAAP exposure drafts.

The preamble, generally speaking, introduces the concept of Statutory Accounting Principles (SAPs). It provides background, purpose, history, and scope. It formulates basic concepts of statutory accounting principles, and it defines that the statutory accounting principles use GAAP as a starting point. So they start with GAAP, and they decide whether to embrace or reject GAAP principles.

New GAAP guidance is specifically excluded from SAPs until the NAIC Accounting Practices and Principles Task Force decides to accept or reject it. The initial codified manual reviewed all the GAAP guidance through December 31, 1996. Much of their work prospectively has been considering Statements of Financial Accounting Standards (SFAS) and Emerging Issues Task Force (EITF) abstracts that have been issued since December 31, 1996. That's what many of the 29 interpretations that they've issued to date relate to.

The preamble, which I'm still on, defines various concepts, and I'm not really going to go through these in a lot of detail, but they're useful. We'll see where the preamble falls in the statutory hierarchy in a second, but it falls pretty low in the statutory hierarchy. At the same time, it defines various key concepts to statutory reporting. It defines the intent of statutory accounting, and it defines the concept of conservatism. So the preamble embraces conservatism and consistency and conservatism provides protection to policyholders against adverse fluctuations in financial conditions or operating results.

With respect to consistency, it says that meaningful and comparable financial information requires consistency in the development and application of statutory accounting principles.

It defines the focus of SAP. In the recognition section, it identifies the balance sheet as the primary focus. The ability to meet policyholder obligations is predicated on the existence of marketable assets available when current and future obligations are due. So based on that statement, assets that might be unavailable should not be recognized on the balance sheet, but charged to surplus. Likewise, liability should be recognized as incurred and conservatively estimated.

It also discusses materiality, and it says that materiality hinges on whether users and reliers of the financial statements would be influenced by the inclusion or correction of the item in question. I've already touched on maintenance, but that's discussed in the preamble as well.

In terms of the statutory hierarchy, the SSAPs are the Level 1 guidance and, in that respect, any GAAP guidance that the NAIC has embraced would also be included. In the GAAP hierarchy, that would be categories A, B, and C. Level 2 in the statutory hierarchy is consensus positions of the NAIC Emerging Accounting Issues Working Group. Like I said, there are 29 already. I'm sure there are more than that, actually, that haven't made it into the manual as well, that have been adopted during the course of this year. Level 3 is the *Annual Statement Instructions* and the *Securities Valuation Office (SVO) Purposes and Procedures Manual*. Level 4 is the portion of the preamble entitled Statutory Accounting Principles Statement of Concepts. Level 5 is GAAP reference material below category C.

The box below shows the structure of an SSAP. It just gives you an idea of how to work through and find the relevant literature and issue papers. Like I said, you might even wind up going back to the preamble, itself, to get some general ideas of what concepts are embodied in codification.

NAIC Codification: Structure of an SSAP

- *Title, Status, Outline of SSAP*
- *Status*: Provides type of issue addressed, when issued, effective date, which pronouncements the SSAP affects, and the pronouncements that the SSAP is affected by.
- *Summary Conclusion*: Authoritative accounting guidance, required disclosures, relevant literature and effective date and transition.
- *Outlines of Authoritative Literature and Relevant Issue Papers*
 - Authoritative Literature: GAAP related accounting material, etc.
 - Issue Papers: Provide additional guidance and background. SSAP governs if issue paper is inconsistent with final SSAP guidance (Preamble).

Let's start with fundamental statements. I've noted four fundamental statements with respect to NAIC codification. SSAP 4 is Assets and Nonadmitted Assets. This standard defines asset characteristics, generally, and it defines nonadmitted assets as those that are specifically identified by codification as nonadmitted or, two, those that are not specifically identified as admitted by codification. Many of these new INTS that are coming out are being issued as a result of new asset categories that are developed by insurers that the NAIC doesn't believe are included in any of their general standards of practice, so they need to be identified specifically as an admitted asset.

SSAP 5 deals with liabilities, contingencies, and impairments of assets. It defines liabilities using GAAP concepts. So you reflect the loss contingency or asset impairment if, one, it's probable and, two, the amount can be reasonably estimated. Another item of note here is in the unlikely event that a reasonable estimate or a best estimate of a loss cannot be determined, it requires use of midpoint of the range. This has been an issue particularly with respect to property and casualty coverages, where you can have a wide range of estimates from zero to millions of dollars, and it requires use of a midpoint of that range if you can't, for some reason, reach a best estimate.

SSAP 3 is Accounting Changes and Corrections of Errors. A change in accounting principle runs through surplus. A change in accounting estimate runs through income. Corrections of errors run through surplus.

SSAP 1 is the general disclosure of accounting policies, risks, and uncertainties, and other disclosures. It expands the current guidance relative to accounting policies, risks, and uncertainties. It also refers to two appendices, Appendix A001, which is a fairly detailed investment disclosure, and Appendix A205, which is the disclosure of differences between prescribed and permitted practices and those defined by the codification.

With respect to invested assets, I've identified several SSAPs and included the appendix on investment disclosure as well. With respect to interesting points, there's now an impairment test, and Jim will get into how this might have an impact on some of the RBC factors later in this presentation. Besides a temporary decline in value, the cost basis shall be written down to fair market, and the writedown is accounted for as a realized loss, the new cost basis shall not be changed for subsequent recoveries in fair market value.

With respect to acquisitions and dispositions of assets, they're to be recorded on the trade date rather than the settlement date. With respect to real estate, this is another one that Jim will get into. The classification of real estate was revised from the annual statement's current presentation to a GAAP basis occupied by the company, held for production of income, and held for sale. You would use an appraisal value for fair market value, which must be five years old or less. As I indicated, there's an investment disclosure required. I didn't indicate that that is due April 1. It's not technically part of the statement, but it's due later.

With respect to other assets, I've identified several other SSAPs and the impacts they might have under codification. SSAP 25 expands the current statutory guidance to include disclosure of all material-related party transactions.

SSAP 46, Subsidiaries Controlled and Affiliated Entities, allows three valuation alternatives rather than five. Second, the equity method share of undistributed earnings runs through unrealized gains until distributed.

SSAP 68, Business Combinations and Goodwill, now allows positive goodwill, which is allowed up to 10% of capital and surplus, where that limitation really applies to goodwill, electronic data processing (EDP) equipment, and any net deferred tax assets. Goodwill is amortized over the period of economic benefit not to exceed ten years.

SSAP 73, Health Care Delivery Assets, provides for admission of some of these assets, provided they're used for direct delivery of services to fulfill policyholder obligations. There is some controversy here with respect to depreciation of some of these assets. That's receiving ongoing discussion at the NAIC. Right now, they're required to be depreciated over three years. Certain entities in the health industry say that for some equipment they're using as long as a 20-year depreciation period, which is justified from their actual experience.

SSAP 16, Electronic Data Processing Equipment and software, allows EDP and operating software to be admitted up to 3% of capital and surplus, depreciated over a three-year period. There is a change being contemplated there. The NAIC recently met and is in the process of changing some of these rules.

The last item is SSAP 10 on income taxes. That will be covered throughout Jim's presentation. It requires deferred tax liabilities and allows deferred tax assets subject to limitations. One major issue with respect to some of these new assets that are being admitted relates to the arbitrary limits of 10% of capital and surplus on certain items.

As for other assets, there is SSAP 6. It is Uncollected Premium Balances and Bills Receivable for Premiums and Amounts Due from Agents and Brokers. There's now a collectibility analysis required. If it's determined to be uncollectible, it's written off regardless of the 90-day aging guidance. This is, I believe, an issue with respect to some P&C coverages, where current statutory accounting for direct bills is based on the policy effective date and for agency billed is

from the statement date. I'm not exactly sure what has been resolved with respect to the issue. As I recall, the regulators were somewhat unsympathetic to modification of this guidance.

We finally get into some actuarial issues with respect to life company premiums and reserves. SSAP 50 defines insurance and managed care contracts, and it groups them into four broad categories, which are life, accident and health, property and casualty and deposit-type contracts. It's worth noting that they deviate from the GAAP guidance with respect to deposit-type contracts; they defined those as contracts without any life or disability contingencies. It specifies that this classification is determined at inception of a contract and that classification will not change prospectively. One question I have here is what is the guidance with respect to some combination contracts? It's still an issue that I'm sure people are going to be wrestling with.

SSAP 51 is titled Life Contracts, and it is consistent with current statutory guidance, with the exception that it eliminates the cost of collection liability. This standard references appendices and actuarial guidelines using the terminology "shall meet the provisions of." This language is in all of the standards that really deal with actuarial reserves: SSAP 51, Life Insurance; SSAP 52, Deposit Type Contracts; SSAP 54, Accident/Health Insurance; SSAP 59, Credit Insurance. It incorporates these items, including the appendices. These appendices include model regulations and even actuarial guidelines. I say actuarial guidelines because it's curious to see that Actuarial Guideline 13 on the Commissioner's Annuity Reserve Valuation Method (CARVM), recognition of bailouts, contingent surrender charges, and so forth appear in two places in codification. It's in one of the appendices, and it's now in another appendix because it is an actuarial guideline.

This standard applies to policies issued after January 1, 2001. At the last NAIC meeting, the new synthetic GIC model regulation, the separate accounts with minimum guaranteed benefits under group contracts, and Regulation XXX have all been included in the appendix. Again, these regulations would be stripped of some of the nonreserve, nondefinitional aspects contained in the model regulation and just focus on accounting and reserving.

I believe the effective date is also excluded. In terms of this new adoption, the Codification Working Group or Statutory Accounting Principles Working Group was very clear that these

model regulations, with respect to codification, would be effective January 1, 2001 as well. There's a slight gap with respect to XXX in the sense that not all states adopted XXX effective January 1, 2000. So there will be situations where a company wrote business in the year 2000 and won't have to disclose the difference in reserves on that business in their annual statement, because codification says disclose the differences beginning January 1, 2001 with respect to deviations from prescribed or permitted practices. I will go through an example of the process of adopting a new model regulation into codification in the handout. I prepared this in 1999, and now XXX has actually gone through this set of working groups and is actually in the manual.

The emphasis in SSAP 52, Deposit Type Contracts is contracts that do not contain any life or morbidity contingencies, and it identifies and describes contracts that would fall into that category. Amounts received as payments for such contracts will not be reported as revenue, but shall be recorded directly to the appropriate policy reserve account. Payments that represent the return of policyholder balances shall not be recorded as expense, so this is a big change under codification. Of course, interest credited would be recorded as an expense. It's, essentially, an *SFAS 97* type presentation for deposit-type contracts now in the SAP Guidance.

All of these SSAPs and their references are effective January 1, 2000 for reserving. Accounting would be effective immediately. Although, if you just read a SSAP, it's not really clear that that's the case. The SSAP, itself, says it's effective January 1, 2001.

SSAP 54, Individual and Group Accident and Health Contracts, refers to Appendix A010, which is essentially the Model Regulation on Minimum Reserve Standards for Individual and Group Health Insurance Contracts. So this is now incorporating into codification a model regulation that previously was not very widely adopted. The SSAP requires contract or additional reserves for level and step-rated contracts. When premiums and benefits are not incurred in the same incidence over a policy period, reserves would be required. It incorporates the concept of reserve adequacy as the ultimate test of reserves. It defines premium deficiency reserves and, again, applies January 1, 2001.

SSAP 55 is a fairly interesting SSAP. It refers to unpaid claims, losses, and loss-adjustment expenses. It applies to all contracts, life, accident, and health, and property and casualty. It incorporates the concept of management's best estimate. For unpaid claims, unpaid losses, and loss and claim adjustment expenses, the liability shall be management's best estimate for each line of business and for all lines of business combined. The reference to the best estimate raises a lot of questions. One question is, does codification allow for a margin in claim liabilities? You really need to look back to the preamble, where it introduces this concept of conservatism to get to the point where you would be taking a fairly standard approach to setting claim liabilities.

I've already talked about the midpoint of the range and the fact that if management cannot reach a best-estimate liability, then the midpoint of the range of possible results shall be recorded. This is a fairly large issue for property/casualty losses. Discounting claim liabilities is limited to workers' compensation tabular indemnity reserves, and long-term disability on property/casualty contracts. Again, this guidance would be effective for all contracts, not like some of the active life tabular reserve ideas presented earlier.

SSAP 61 is the Standard on Life Deposit Type and Accident and Health Reinsurance. Again, it adopts the reinsurance model regulation via Appendix A-791. Everyone is familiar with this model regulation and the fact that there are a set of questions and answers that have been developed by the Life and Health Actuarial Task Force to try to clarify certain aspects of the model regulation.

The questions and answers are actually incorporated into the issue paper that was prepared prior to the SSAP being written, and some of the more controversial issues were referred back to the Life and Health Actuarial Task Force to try to reach a consensus on several of them. I believe they reached a consensus on a couple of issues. Asset segmentation comes to mind. I'm not exactly sure where their response lies in terms of whether there's going to be additional guidance incorporated into the next version of a codification manual. Again, there are specific transition rules with respect to the life reinsurance chapter.

SSAP 59 is titled Credit Life and Accident and Health Insurance Contracts. I just want to point out that there is fairly specific guidance and standards depending on the type of coverage (single premium versus annual premium). State valuation requirements have varied historically. I believe the NAIC is currently discussing exactly how a cash-value floor concept is to be reflected with respect to some credit coverages.

Finally, SSAP 35 is titled Guaranty Fund and Other Assessments. Codification now provides for accrual of these assessments when the insolvency incurs, which poses a problem that has been identified, particularly for P&C companies. You might only know from the guaranty funds what the next year's losses are expected to be. The NAIC is now asking most companies to estimate what the run out for 15 years or longer might be. Codification forces this accrual, and there's really insufficient information to make it. There's an issue with respect to premium taxes and premium tax offsets and how they're recognized.

In terms of conclusions, I would say asset valuation begins immediately, January 1, 2001. Taxes, which Jim will discuss, reflect codification guidance immediately (January 1, 2001). Policy reserves are valued according to existing statutory guidance (in the state of domicile) at the date of issue for December 31, 2000 and prior issues. I'm sure every model law and regulation that refers to reserving practices, in one way or another, will ultimately get incorporated into Appendix B. Actuarial guidelines appear to be more highly regarded and not necessarily guidelines in terms of what you'll need to be doing with respect to reserves for business issued after January 1, 2001.

I think the intent is for the Accounting Statement Presentation changes to apply immediately to all business. There have been annual statement changes to ensure that that takes place already. With respect to claim reserves, follow codification immediately, so the concepts of best estimate and midpoint are immediate. The last point is the process for actuarial guideline development might change over time, since it seems like the actuarial guidelines are being given more significance in terms of being incorporated directly into the codification manual.

Let's discuss the disclosure of differences. You need to disclose income statement and balance sheet bottom line differences. Appendix A-205 states that you need to show what differences are created by state prescribed practices, what differences are created by state permitted practices, and what your codified income and balance sheet surplus would look like as compared with what you've illustrated in your statement. Again, the idea is to cause the company and state accounting practices to converge to codification over time because these differences will, ultimately, be disclosed in your blue book.

The maintenance process is fairly obvious. I've indicated that they are studying 1997 and later GAAP guidance and deciding whether to reject it or embrace it. The way that happens is the Statutory Accounting Principles Working Group develops issue papers, and SSAPs, and it holds public hearings for companies to raise concerns related to new standards. The Emerging Accounting Issues Working Group creates interpretations and clarifications of the existing guidance.

Finally, there have been some recent discussions by the Statutory Accounting Principles Working Group related to making sure that blanks changes don't inadvertently create statutory accounting principles changes. They're going to put some more guidance into the manual to say that they're not endorsing any changes that might be created by an Annual Statement Blanks Task Force without authorizing it.

Finally, my handouts show the breadth of some of the different models that have been included in Appendix A to codification. It includes not only the disclosure appendices, but the various reserving standards. Keep in mind that you need to add three more model regulations to this: the Synthetic GIC Model, the XXX Model, and the Separate Accounts Model. There are some other standards that just introduce, essentially, definitions that they want to make sure are clear in codification.

Now let's discuss some recent events at the NAIC meeting. I've already discussed some of these. It has adopted SSAP 74, which deals with protected cells in P&C companies and how you account for them. It is discussing some issues related to health care receivables, particularly,

what, if any, pharmaceutical rebate balances, claim overpayments, loans, and advances to providers should be recognized as assets in statutory accounting. The regulators have perceived that there has been a general lack of discipline and poor recordkeeping on the part of doctors, so they have a big question mark in their heads as to whether to recognize these balances or not. As such, the industry has issued several letters to them asking them to make some consideration for these balances.

Regarding depreciation of nonoperating software, SSAP 16 mentions three years. That has been reduced by the NAIC staff to five years or the useful life, if less. The industry wanted it to be ten years, but didn't get the NAIC to completely embrace that.

Issue Paper 110, incorporates these three new model regulations. On the maintenance agenda, there's a question with respect to certain health care delivery assets that are now admitted. They have attached a three-year depreciation and this is creating some grief for some companies that have some significant writedowns that would be contemplated for certain health care delivery equipment. An example was given as x-ray machines, which might have a depreciable life of as high as 20 years, and this standard is imposing a three-year depreciation. One thing that the NAIC is considering is some transition rule that would force it to be three years from January 1, 2001, rather than three years from the original acquisition date of the equipment. This would provide some minimal relief.

Finally, Jim will let you know that the asset valuation reserve, the interest maintenance reserve, and the recognition of negative IMR is still somewhere on the NAIC's agenda.

MR. REISKTYL: Obviously, this is a major undertaking, and it will continue to be a major undertaking. Ted has done an excellent job of summarizing a lot of the material. I'm going to apply it in three specific areas: AVR, IMR, and risk-based capital. I'll focus on primarily two areas: taxes and the proposed exposure on real estate.

I'm going to take a look at the effect of codification on structure, the factors, and the total adjusted capital (for RBC only). To date, we have focused on structure. We hope that by

December, but it might take until March, we'll actually see what change in factors will occur. So we reviewed every one of the SSAPs that Ted described to see what impact they might have on AVR, IMR and RBC. We asked experts to review them. We developed possible issues and sought input. In fact, if you have any ideas, we welcome your suggestions or questions.

I will go over the impact on each SSAP very briefly. In doing so, I'll repeat a few things that Ted said. During this process, we also looked for ways to simplify things or improve them at the same time because this is an excellent time to do that.

If I were to summarize the changes, I'd say codification has replaced a variety of acceptable accounting choices with one prescribed process. So the impact, particularly on risk-based capital and total adjusted capital, will vary depending on whether your company's current procedures are consistent with those adopted by the NAIC. Or, if you were using some other procedure, you will have to change, and it could be modest or significant.

Hence, it is very difficult to estimate the total impact of codification on total adjusted capital. We simply don't know since it depends on what companies are doing today and you don't report on what procedures you're following. Most times, we have to estimate. You will see that the impact of a lot of these SSAPs is likely to be on the total adjusted capital. Rarely will it affect the AVR or the IMR, except for taxes, and that's a big change for most companies.

Second, the single biggest change for most companies probably will be taxes, or more specifically, recognition of deferred taxes. In the future, you will recognize deferred tax assets and deferred tax liabilities. How big are they? Current deferred tax liabilities could be quite large, since the stock market has done very well for the last few years. Hence, one would assume, unless you have unusually poor stock pickers, you will have a significant deferred tax liability on your common stock appreciation.

Deferred tax assets that will be recognized in the statement are a lot more difficult to estimate for a variety of reasons. One is the NAIC didn't just adopt deferred taxes. They put in multiple criteria that you have to meet to recognize deferred tax assets; any excess over the limit is

nonadmitted. Trying to estimate how large it might be depends on many factors, including how large your deferred tax liabilities are, so this one is very difficult to assess. Nevertheless, deferred taxes are probably the biggest single change of codification for most companies. On the other hand, if all you sell is variable products, it might have very little impact on your results. So when I say this, I always hesitate because, depending on what your lines of business might be, the tax impact might be significant or very modest.

Let's go through a few details. I'm going to do this fairly quickly, and then I can come back, if you'd like, to these items in greater detail.

First, the new definitions of cash and short-term investments are not likely to have any material change on either one of these reserves. Assets are defined. The changes will have little impact, and, for the first time, liabilities are defined. The NAIC, as Ted referred to earlier, have adopted the GAAP criteria. You're going to have to get familiar with the terms: is it probable, and if it is probable, what is it reasonably estimated to be? Risk-based capital and total adjusted capital could be lower if companies become more diligent about how they deal with things like asset writedowns that are probable and can be reasonably estimated. As far as electronic data processing equipment, the NAIC has tightened the rules for depreciation and that, too, could have some effect on the total adjusted capital.

Ted mentioned the three significant changes pertaining to bonds. One is the trade date/settlement date. I don't think that change is going to have much effect on AVR or risk-based capital.

Second, the fact that you're now recognizing prepayment penalties as income will have some modest impact. The third and probably the biggest single thing and the one that's most difficult to assess is changing something when it is written down. Once it is written down, it stays there forever and, presumably, you'll do this quicker. The question then becomes, if you recognize things quicker, does that raise or lower the RBC or AVR impact? Some would suggest, if it's quicker, it ought to be higher and some would argue it's lower, because you're doing it consistently. Which side are you taking on this issue? In either case, we believe the impact will be modest. Given the difference of opinions, if the laws of nature work, they'll balance each

other out, and the overall industry impact will be modest. But it could affect your company more than others, and you should take a good, hard look at this change.

Guarantee fund assessments must be established as liabilities, with appropriate premium tax offsets. Some of you have been setting them up, and some of you haven't. We'll have consistency, and the impact is likely to vary. We think it could lower the total adjusted capital because there will be more recognition.

There will be more disclosure of financial instrument information, off-balance-sheet risk, concentration of credit risks, and the fair value of financial instruments. The long and short of this one is that we think the RBC rules are already higher so there won't be any change.

The factor applied to off-balance-sheet data will probably be 1%, and we will not drop the long-term leases from sensitivity tests.

SSAP 36 deals with troubled debt restructuring. We will still have restructured mortgages and will continue to use the factors. This is one example of standard recognition of losses; therefore factors might go up or down because it's faster and more consistent? You can help us determine the change. I think the impact will be modest.

SSAP 37 pertains to mortgage loans. We'll continue the current risk categories. There are strong arguments for changing the mortgage experience adjustment factor to bring it into a more probabilistic structure. We decided to not recommend change at this time.

SSAP 40 is on real estate investments. I will spend a little additional time here because we presented an exposure draft for change due to codification at another session. We are looking for comments and suggestions. Please make your investment people aware of it, too. The accountants are generally moving toward a better risk-based-accounting-type reporting. Unfortunately, in the case of real estate, they adopted the GAAP-type definitions which, of course, have nothing to do with risk structure. These are held to maturity or available for sale. What does that have to do with risk? Very little. We have lost some very useful information.

We have two choices. We can either continue to request the information, as we have before, and continue RBC and AVR just like they are, or we can go to the new proposal that is being exposed. We are not recommending it at this point; we're exposing it. More accurately, the NAIC is exposing it for comment, without recommendation.

The new proposal calculates AVR and RBC requirements based on cash on book returns done on a company portfolio basis, not property by property. We're doing one portfolio calculation. That admittedly covers up a lot of things that you would get property by property. So you have the age-old trade-off between simplicity and preciseness. We went for simplicity with limited preciseness.

What is it? Cash, hopefully, is obvious. That's the amount of income you take in, less the expenses and the interest income before depreciation. For those of you who love details, it would be Schedule A, Column 13, minus Column 14. I wrote it down, because I don't memorize this kind of thing. The denominator is the average book value (average over two year-ends). We might do it quarterly. This would pick up the changes in your portfolio that occur from time to time. If you make a significant change in your investment strategy, this could have an impact.

Specifically, if the cash on book return is 6% or less, the factor will be 20%. If it's 9.65% or greater, it's 3%. How did we ever come up with such a factor to two decimal points? We attempted to put the RBC on roughly the same industry level that it was today. The 9.65% was selected so that over a real estate cycle, it will produce about the same answers as the current factors. The real estate life cycle is assumed to be about 20 years. The data supporting this is in our report, which is available to you. In college, my professor said you only know business cycles after they're over, and I suspect that is also true of the real estate cycle. Real estate has historically had a cycle.

One linearly interpolates between these two factors. What this proposal says is when returns are high, things are probably pretty good and risks are low. Low returns are indicative of higher future risks. It is fairly predictive. It accounts for about 30% or 40%, so it's not perfect. When

we actually looked at the historical results of 20 companies, it was in the 70% range. It is also designed to do a couple of other things.

If you've invested in a newly developed property, the return is lower and the risks are higher. This proposal will reflect that risk. It should be more responsive to change, and it will have full tax recognition. I'll pause a moment to see if it raises any questions that you want to ask before I go onto the next topic.

FROM THE FLOOR: When you say 6% or 9.65%, that's 6% of cost?

MR. REISKTYL: That's the ratio when you divide the cash return by book value. You're going to get a number, and if that number is 6 or 9.65, that's just income divided by book value.

FROM THE FLOOR: Could you give us a time frame for adopting this proposal?

MR. REISKTYL: The time frame for adopting would be next year, assuming everything goes well. We can always fall back to the current structure from company records. It was exposed on Monday and the exposure period runs until October 31, 2000. I want to make it very clear that this is just a concept exposure. It's not exposure for adoption. The next step will be based on the comments in December to possibly expose it for adoption in the following year.

Earlier I said our goal, to be accomplished by year-end, is to finalize the structure and then develop the factors. Any other questions?

Next is SSAP 42. Premium receivables is just expanded guidance. It could have a modest impact on total adjusted capital. Similarly, with joint ventures, partnerships, and so on, we don't believe the changes will have much effect. For goodwill, SSAP 68, the rules vary depending on whether it is a purchase or a merger, and they are determined based on the enterprises that are left. Ted described the limits on goodwill. We've been considering whether it should have the RBC equity factor of 30% or the investments in subsidiaries or the controlled and affiliated entities factor of 22.5%.

The haircut in the new rules in SSAP 46 provides some risk cushion. Frankly, this is a good example where the life, the health, and the property/casualty RBC people worked together and concluded that 22.5% of the excess of the statement value over the haircuted market value would be appropriate. We not only have the structure, but also the factor.

There has been quite a bit of state variation for individual and group accident and health contracts, so the impact will depend on the company's current procedures. Health care delivery asset issues were turned over to the health RBC group and they haven't finished their deliberations. From our perspective, the issue is whether they are to be treated as real estate (with a 10% factor) or some portion of it as equity at 30%. Perhaps if these assets are 20% or less of your total assets, the real estate factor is appropriate. As this percentage increases, the factor will move closer to an equity factor.

Ted covered unpaid claims well, so I won't say much more. We're at the midpoint versus the low point. For loss adjustments, the expenses will be built in and that will have a modest impact on some companies.

The most significant change occurred in the treatment of taxes. Are you knowledgeable about taxes? I don't want to tell you what you already know, but maybe it would be useful to go over it briefly.

First, the current tax liability is a current expense with no change. Sometimes you skip over the obvious, and the current liability continues just like it is. What's new? There's recognition of deferred taxes. If you are familiar with GAAP, this is not a new concept, but it is a new concept in statutory accounting. However, they didn't just simply adopt it. They also established a series of criteria for determining when deferred tax assets will be recognized, one of which requires that it be recoverable in the next year. If it is recoverable in the next year, then you look back to the last three years to make sure that the company has paid some taxes. On top of that are three other criteria. The deferred tax asset up to the deferred tax liabilities is always recognized.

These recognition/nonrecognition rules must be carefully followed. Today, I am only going to deal with the general concept of deferred taxes. What changes? Deferred tax recognition has implications for both AVR and risk-based capital. The current factors do not reflect deferred taxes. They do reflect various tax assumptions by factor. For example, if you pay a mortality claim you didn't expect to pay, it's tax deductible. There's no doubt about recognizing taxes to partially offset the claim if you are a taxpayer.

When you come to an asset default occurring sometime in the future, it isn't so clear. Did you write it down? Did you recognize the writedown for taxes? Today, you have to decide whether the default was realized for taxes or not and reflect that assumption in developing the factors. Deferred taxes will pick up the losses, whether or not they were recognized in the tax return. Any difference between your accounting system and your tax results are picked up in deferred taxes, subject to those limits. Hence, recognition of deferred taxes will change the AVR and the RBC factor, especially for common stock.

Some people get all tangled up in the current amount of deferred taxes that are recognized. Of course, we're dealing with future adverse event(s), so we're not sure what the deferred tax assets (DTA) or liabilities (DTL) might be at that time. If you know, you are a very good actuary—a better one than I am. We generally concluded we would ignore the limits in determining factors and introduce a sensitivity test. If deferred tax assets exceed these criteria, you still have a deferred tax asset; it's just not admitted. It's calculated and set aside. Whatever the DTAs and DTLs are, and they will vary from year to year, our recommendation is that they ought to be recognized as part of total adjusted capital, just like any other change resulting from codification. We shouldn't recognize only selected items.

Seven recommendations for taxes were recently made by the Academy. I will briefly describe them, and after that, you can ask questions, if you like.

The first recommendation is consistency of structure and assumptions for all factors. We plan to make all the life factors consistent; we then hope the health and property and casualty will do the same. Today, the formulas and factors are not necessarily consistent, so that's our first goal.

We also recommend separating all factors and results into taxable income and capital gain/loss items, which has not been done directly in the past. We did it indirectly, by applying different factors to different risks.

That leads to our next recommendation, which is to do all RBC factors pretax, add up the risk assessments by total income items and total capital gain/loss items (just like a tax return) and then apply an appropriate tax factor. As you know, whether you apply taxes to each factor or apply them in the aggregate, you should get the same answer, except for rounding, as long as you do it precovariance. This change, however, will make it simpler to make future changes. If the capital gains rate or the income tax rate is changed, you don't have to go back to change all the factors. You can simply change one or two factors or possibly a few more depending on final decisions.

The tax rate, itself, is not part of this structural recommendation. It could be the current corporate tax rate. That's what you would use for marginal tax analysis. On the other hand, you could use something less than the full rate for everything or vary the rates, depending on the RBC factor, which is probably the most likely choice. For example, you might use the full rates as I suggested earlier for future mortality or morbidity claims. You might use something in between 17.5% and 35% for capital items, because of the deferred asset limitation. It should be larger than the current 17.5% (or one-half of 35%).

We're also proposing a sensitivity test for life RBC that assumes no DTAs, no DTLs, and no taxes. If, on that basis, the company would be subject to regulatory review, the regulator is alerted via a quick, simple, early warning test to companies that might need further review of their individual tax circumstances.

We also recommend that the tax factor should be based on broad, general industry averages rather than individual company experience and circumstances. We do not recommend company-specific tax rates because these can be quite complicated depending on things like tax-sharing agreements, brother/sister relationships, consolidated or unconsolidated results, and whether the company is a holding company or owned by another company. These can and should be

considered if the company becomes weakly capitalized. The general approach prior to that is consistent with the general determination of RBC.

These recommendations will be discussed with the regulators in a conference call in the near future. Once finalized, we can move on to the factor determinations.

We have completed our review, made our recommendations, and we are trying to coordinate these changes with the other two non-life RBC groups.

For AVR, there's likely to be no structural changes. They will change all maximums and structure to be consistent with RBC changes. We are, however, recommending that the AVR factors be done on an after-tax basis. I just heard you say you wanted RBC factors to be pretax. Why are they different? This is due to the timing of the NAIC statement and instructions. AVR is part of the blank. RBC is calculated separately and results are entered into the blank.

An instructional change to the annual statement made now will be effective in 2003. If we want to bring AVR into line with RBC next year, we have to do AVR factors on an after-tax basis. We might be able to change factors, but can't change the instructions. A change in the instructions is to add a tax line. A change in a factor is not.

As to RBC, except for taxes, there are very few significant changes, but we will have greater consistency. The biggest, single result of consistency is its effect on total adjusted capital.

So what's left to do? Finalize our recommendations. We are looking for input. Then develop final factors for both AVR and RBC. When all is done, we might have to recalibrate RBC levels for weakly capitalized companies. It's a little difficult to do that at this point because we don't know exactly what the impacts will be on total adjusted capital for individual companies.

Ted and I have given you an overview of codification—the highlights and key things that you should think about like reserves, risk-based capital, the asset valuation reserve, and the investment maintenance reserve. We will now take questions.

FROM THE FLOOR: I have three questions. First, in terms of the actuarial guidelines migrating to the appendix, will that affect tax reserves? Will this upgrade enable reserves required under the guidelines to meet the 26-state standard?

MR. SCHLUDE: The guidelines are effective January 1, 2001. The methodology, with respect to reserves, applies to policies issued after that point in time. I think the federal guidance for standards for mortality tables is pretty clear.

MR. REISKTYL: From a tax perspective, it surely can't do any harm, and it could help because it's going to make it more explicit that these are recognized as part of the codified structure. There has been broad recognition as you're well aware of the guidelines to date. Of course, each state has to adopt them to meet the 26-state mortality table standard. One could argue that it's just the same, but surely sameness could reinforce the argument for acceptance.

FROM THE FLOOR: My second question is on the relationship between deferred tax assets and AVR. I've been concerned that, with the way things are structured now, we can have anomalies, like an unrealized equity capital gain, that would be fully reserved for in the AVR. It would also require the setting up of a deferred tax liability, which could result in a drop in statutory surplus. My impression was the AVR Working Group was looking at such issues. I'm also under the impression that there are a lot of people who don't care what happens to AVR. But for those of us who are concerned about statutory capital, in terms of dividending up to our parent, it is a matter of concern.

MR. REISKTYL: Right. As you have suggested, it's our objective to reflect codification changes and not double count anything. Deferred taxes will reduce unrealized equity gains so the AVR and statutory capital will be lower. Deferred tax assets, on the other hand, will increase surplus. As for the AVR, particularly for fixed-income assets, it is good accounting and really is a reserve and part of cash-flow testing. Whether you call it an AVR or call it a contra asset or part of life insurance reserves, the AVR will be there in one form or another. But that's a whole separate issue.

FROM THE FLOOR: The third question is, are you proposing that deferred tax assets, to the extent that they are not recognized, will be added to RBC capital?

MR. REISKTYL: The total adjusted capital will only recognize the admitted portion. It will not recognize the nonadmitted portion.

FROM THE FLOOR: May I suggest that that be considered?

MR. REISKTYL: Sure, it is duly noted.

FROM THE FLOOR: With respect to the reference of a best estimate, on one hand, and then conservatism, on the other, do you think codification supports a point estimate with an explicit margin as a best estimate or should the best estimate just be inherently conservative (i.e., an implicit margin)?

MR. SCHLUDE: I would argue that the guidance doesn't change anything you're already doing. So if you're establishing a best estimate with a margin (even though you might not get there), and if you consider the SSAP on claim liabilities, you can still go back to the preamble and embrace those concepts of conservatism or refer to the Actuarial Standards of Practice.

MR. REISKTYL: As a tax man, anytime I hear adding margins, I cringe. I'd much rather talk about probabilistic standards. Reserves meeting, say an 80% or 85% criteria, have a lot more charm than a best estimate at 50% plus margins, and they add a lot of conservatism.

We've had sessions at the Northwestern on sensitivity training as to people's culture. I'm trying to raise your sensitivity to strike the word conservative out of your reserve vocabulary. Talk instead about probabilistic criteria, for two reasons. First, it's appropriate. Second, it puts the criteria clearly in the actuarial ballpark, whereas, anybody can add a margin or provide for a level of conservatism. I think any statutory reserve should meet one simple criteria: it should be 80% or one standard deviation. I would hope anytime you say conservative, or add margins to best estimates, that your throat tightens up.

FROM THE FLOOR: You need to rework the preamble then.

MR. REISKTYL: There is a lot of work to do, beginning with actuaries. Anything else you'd like to talk about? Any impression on the size of deferred tax assets? Or liabilities? I've heard some people say it's zero; some say it could be huge. How about a show of hands? How many of you think you're going to have an admitted deferred tax asset? It looks like there are just two.

FROM THE FLOOR: Not in New York.

MR. REISKTYL: We've got one. New York was never charmed by this, but I thought it was going to permit it. Because only a couple of you raised your hands, does that mean the rest of you don't know? That makes me feel better.

MR. DANIEL J. MCCARTHY: With the elimination of certain cash-flow elements for products that will be recorded as deposit-type contracts, how will this impact other schedules in the annual statement, such as the analysis of increase in reserves?

MR. SCHLUDE: I think the question relates to the elimination of certain annual statement items, such as premiums and benefits, from the blanks for products with deposit accounting treatment and how that would be reflected when you prepare the analysis of change in reserves from year to year. I guess I haven't really thought what that will do, but it's a good question.

FROM THE FLOOR: That's true even though it might not be reported as such.

MR. SCHLUDE: Maybe it's defined in the analysis of an increase in reserve as the interest credited on deposit contracts. So it might just fall into a tabular interest. It is one item, and you're done.

MS. KATHARINE BRANDT YOUNG: We recently received the new blank to review. There is no deposit-type section on page seven, which is the analysis of increase in reserves. It has all been moved to Exhibit 10. Exhibit 10 now has its own analysis of increase in reserves.

MR. SCHLUDE: Good.

MS. YOUNG: So I think we will have to use a GAAP approach of recording those items and then having an adjustment to get them out of the income statement, but preserve them for the analysis of increase in reserves.