



# NAIC Meeting Notes

GLOBAL INSURANCE INDUSTRY GROUP, AMERICAS

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## NAIC 2006 SPRING NATIONAL MEETING

The National Association of Insurance Commissioners held their 2006 Spring National Meeting in Orlando March 3-7. This newsletter contains information on activities that occurred in some of the committees, task forces and working groups that met there. For questions or comments concerning any of the items reported, please feel free to contact us at the address given on the last page.

### Executive Summary

- At their Executive and Plenary sessions, the Commissioners adopted seven new or revised model regulations and white papers including the U.S. Reinsurance Collateral White Paper and also adopted a new charge for the Reinsurance Task Force to begin developing alternatives to the current reinsurance regulatory framework. (page 3)
- The Statutory Accounting Principles Working Group approved a new issue paper, Issue Paper 127, Exchanges of Nonmonetary Assets, and adopted as final guidance on accounting for prepaid reinsurance. The working group also voted to expose for comment a new SSAP 94, Accounting for Transferable State Tax Credits, and Issue Paper 128, Settlement Requirements for Intercompany Transactions, which would require specific due dates for intercompany receivables and nonadmission of amounts over ninety days past due. The working group heard a report from Interested Parties that concludes that P/C companies cannot fully comply with the guidance on accounting for guaranty funds assessments required by SSAP 35 due to lack of data. (pages 3-5)
- The Emerging Accounting Issues Working Group finalized one Interpretation which nullifies the guidance in INT 03-01 on the Florida Hurricane Catastrophe Fund, and reached a tentative consensus on accounting for revenue from the sale of claims data and accounting for investments in Certified Capital Companies. (pages 5-6)
- After more than two years of hard work and innumerable conference calls, meetings and public hearings, the NAIC/AICPA Working Group voted to adopt proposed changes to the Model Audit Rule which incorporate certain provisions of Sarbanes-Oxley related to corporate governance, management reporting on internal controls and auditor rotation partner. The working group's parent, Financial Condition (E) Committee voted to expose the proposed changes for a 45 day comment period with a public hearing in May. In the meantime, the working group and its Interested Parties group will turn their attention to the development of an Implementation Guide to assist insurance companies in adopting the new guidance. (pages 6-9)
- The P/C Reinsurance Study continues to focus on considering enhancements to its risk transfer guidance and heard a report from the newly formed Risk Transfer Work Group of the American Academy of Actuaries that will be addressing three broad categories of risk transfer issues: risk transfer safe harbors and definitions of when risk transfer is "reasonably self-evident," technical issues in risk transfer testing and risk transfer testing issues regarding data, methods and interpreting results. The study group also concluded that no change will be made to paragraph 51 of SSAP 62 for the calculation of the excess

ceding commission liability, but the study group will consider guidance on amortization of the liability at the Summer National Meeting. (pages 9-10)

- The Capital Adequacy Task Force approved Medicare Part D prescription drug RBC underwriting factors for 2006; the regulators also heard an update from the Catastrophe Risk Subgroup of the P/C RBC Working Group regarding its progress on a project to determine the appropriate treatment of catastrophe risk. The Life Risk-Based Capital Working Group is moving quickly in considering expansion of C-3 Phase I interest testing to all companies except those with less than \$100 million in assets. (pages 10-11)
- The Valuation of Securities Task Force continued its discussion of principle protected notes and there is still no consensus between interested parties and the task force on the valuation of impaired PPNs. The chair asked NAIC staff to draft proposed amendments to SSAP 43 on Loan-back Securities that would require the use of discounted cash flows (versus undiscounted) to determine when a PPN is impaired. The task force also approved a recommendation to review the Derivatives Instruments Model Regulation and after very lengthy discussion over many months agreed to approve A.M. Best as a Nationally Recognized Statistical Rating Agency. (page 11-12)
- The Blanks Working Group adopted 18 new proposals that revise the annual statements and instructions that affect 2006 and 2007 statements including enhanced pension disclosures as specified by FAS 132R and adopted by the SAP Working Group (page 15-16)
- The Life Insurance and Annuities (A) Committee adopted amendments to two models: Senior Protections in Annuity Transactions, now renamed Suitability in Annuity Transactions, and Life Insurance and Annuities Replacement Model Regulation. The first model now applies to all consumers, not just those 65 years and older. The committee also continued to urge its Life and Health Actuarial Task Force to stay on schedule with its development of principles-based reserving. (page 16-17)
- The Life and Health Actuarial Task Force exposed a significantly revised version of VACARVM for comment, which now reflects the position of the New York Insurance Department, and which several interest parties believe is overly conservative. In addition to continuing its work on the principles-based reserving project, the task force also adopted Actuarial Guideline ABC, Projections of Guaranteed Non-forfeiture Benefits under CARVM, and revisions to the Variable Annuity Model Regulation to bring the model in line with the annuity standard non-forfeiture law. (pages 17-19)
- The Accident and Health Working Group adopted changes to the Long-term Care Experience Reports and Instructions that are filed as supplements to the annual statements. The working group also reached a tentative consensus that the guidance in INT 02-21 on prepaid loss adjustment expenses should apply to managed care companies. (page 19-20)
- The Reinsurance Task Force heard comments on its proposal to require a reinsurance attestation for life insurance companies that is nearly identical to the attestation adopted for p/c companies; the regulators deferred voting on the proposal pending further analysis by the New York Department of Insurance. The task force also adopted amendments to the Reinsurance Intermediary Model Act to improve the arbitration process. (page 20-21)
- The Risk Retention Group Task Force adopted a tentative consensus that captive risk retention groups that file with state insurance departments using generally accepted accounting principles or another non-statutory basis of accounting should always include a reconciliation to the statutory basis of accounting in their financial statements. (page 22)

## Executive Committee and Plenary

The Commissioners adopted the following new or revised models and white papers:

- Modified Guaranteed Annuity Regulation - the changes are intended to bring the model in line with the Annuity Standard Non-forfeiture Law.
- Risk-Based Capital for Insurers Model Act - The adopted revisions add the P/C Trend Test as a triggering event for a RBC company action level.
- Actuarial Guidance XXXIX: Reserves for Variable Annuities with Guaranteed Living Benefits - The revision extends the sunset date from January 1, 2006 to January 1, 2008.
- Workers' Compensation Large Deductible Study - the study demonstrates that policies with large deductibles are becoming a larger part of the total market
- U.S. Reinsurance Collateral White Paper - the stated purpose of the white paper is "to provide a balanced synopsis of the historical argument in favor of and against amending U.S. reinsurance collateral requirements." The Commissioners also adopted a new charge for the Reinsurance Task Force to begin developing alternatives to the current reinsurance regulatory framework. See page 20 for the full text of the new charge.
- Uninsured Motorists: A Growing Problem for Consumers White Paper
- National Flood Insurance Program White Paper.

## Broker Activities Task Force

The task force and its Settlement Subgroup met only in closed session in Orlando.

## Financial Condition (E) Committee

The committee voted 12-1 to expose for a forty-five comment period the proposed revisions to the Model Audit Rule to incorporate certain provisions of Sarbanes-Oxley with respect to audit committee requirements, management attestation on internal controls and auditor rotation and independence

requirements. As discussed below (page 6), the document had been adopted by the NAIC/AICPA Working Group at its earlier meeting in Orlando.

The committee representative from Utah objected to a public hearing to be held at other than a National meeting due to travel budget concerns and reduced participation by all parties. The committee chair said many regulators are anxious to move the proposal to Executive and Plenary at the Summer National Meeting; after another 12-1 vote, the committee voted for an interim public hearing in May. However, the chair did note that he will not automatically push the revised Model Audit Rule to Executive Committee if they need additional time to review the comments received.

## Statutory Accounting Principles Working Group

### Public Hearing

The working group held its regular quarterly hearing to receive comments on proposals exposed at its prior National Meeting.

Issue Paper 127, Exchanges of Nonmonetary Assets, A Replacement of SSAP 28, Nonmonetary Assets – The working group received no comments on the Issue Paper and voted to adopt the paper as final and directed NAIC staff to draft the SSAP. The guidance adopts FAS 153 on exchanges of nonmonetary assets with some modifications.

Prepaid Reinsurance – The working group adopted as final nonsubstantive changes exposed in Chicago, which provides guidance on the accounting for and admissibility of prepaid reinsurance premiums by both ceding and assuming companies. Because the changes are deemed nonsubstantive, they are effective immediately. The new guidance classifies reinsurance premium paid prior to the effective date of the contract as a write-in admitted asset for the ceding company. The assuming company reports such amounts as advance premium and not with unearned or written premium until the effective date of the coverage.

INT 03-17 disclosure to SSAP 55 – The working group again deferred action on proposed changes to SSAP 55 to require disclosure of claims or losses related to extra contractual obligation lawsuits. Interested parties believe that many companies would not be able to capture this information

without significant systems changes. The working group will hold a conference call during the spring with the Casualty Actuarial Task Force and may include LHATF if the guidance is to apply to A&H contracts as well.

Clarification of SSAP 72, Surplus – The working group adopted as final a nonsubstantive clarification to paragraph 14 of SSAP 72 to provide that contributions received subsequent to the organization phase for non-stock insurers are to be reported in "other than special surplus funds."

#### **SAP Maintenance Agenda Discussion**

All issues exposed for public comment have a comment deadline to NAIC staff of May 15, with a public hearing at the Summer National Meeting.

Issue Paper 128, Settlement Requirements for Intercompany Transactions, An Amendment to SSAP 25 – This new issue paper was presented in Orlando; it was drafted to address the lack of an aging requirement for receivables from affiliates and other related parties. It includes the following proposed new paragraph (par. 6) to SSAP 25:

Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted. If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.

The working group voted to expose the issue paper for comment. The proposed effective date is for periods beginning on or after January 1, 2007.

Report of SSAP 88 Subgroup – This subgroup, formed to address implementation issues of SSAP 88, has met several times in nonpublic meetings since the Winter National Meeting and plans to hold open conference calls during the spring. In Orlando, the working group heard a brief update from the subgroup. One of the issues that the subgroup will be addressing is whether audited financial statements prepared on a non-U.S. accounting basis, such as International Accounting Standards, that include a footnote reconciling the non-U.S. GAAP equity to equity based on U.S. GAAP would meet the requirement in SSAP 88 for the valuation of certain SCAs to be based on "audited U.S. GAAP equity." The subgroup did not

indicate whether they had reached a tentative consensus position.

SSAP 94, Accounting for Transferable State Tax Credits – The working group voted to expose this draft SSAP for comment. The only substantive change made to the issue paper (IP 126) was to exclude investments in Certified Capital Companies (CAPCOs) from the scope of the SSAP, as recommended by both the SVO and Interested Parties. Accounting for CAPCOs was discussed at the meeting of the Emerging Accounting Issues Working Group, which is summarized below.

Disclosure of Supplemental Information within the Annual Audited Report – The working group discussed a proposed amendment to the Model Audit Rule to clarify that certain supplemental schedules are required in the audited financial statements. As part of that discussion, a member of the working group questioned the original intent of the Supplemental Schedule of Assets and Liabilities prepared by life and health insurers (which was to include as a supplemental schedule in the audited financial statements information reviewed by the Opinion Actuary as part of his or her review). The working group referred the issue to the NAIC/AICPA Working Group.

Proposed Changes to Appendix A-010 and SSAP 59, Credit Insurance – The working group voted to expose changes to Appendix A-001, Minimum Reserve Standards for Individual and Group Health Insurance Contracts, to reflect recent changes to the model. Conforming changes are also proposed to SSAP 59. These changes have been approved by the Accident and Health Working Group.

Proposed Change to SSAP 1 and Appendix A-205 – The working group voted to expose nonsubstantive changes for comment related to the disclosure requirements of the effect on risk-based capital when either a permitted practice or prescribed practice that differs from NAIC prescribed is used by a company. The following change (underscored) was proposed to par. 7d. of SSAP 1:

If an insurance enterprise's risk-based capital would have been triggered a regulatory event had it not used a prescribed or permitted practice, that fact should be disclosed in the financial statements.

The proposal also would amend the example footnote in Appendix A-205, Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Prescribed or Permitted by the State of Domicile.

Review of New GAAP Guidance – As part of its charge to address newly issued U.S. GAAP guidance, the working group reached a tentative consensus to reject the following GAAP guidance as not applicable to statutory accounting and voted to expose these conclusions for public comment:

- FAS 151, Inventory Costs, an amendment to ARB 43
- FAS 154, Accounting Changes and Corrections of Errors
- FIN 47, Accounting for Conditional Asset Retirement Obligations
- SOP 03-4, Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships
- FSP FAS 141/142-1

Industry Survey on SSAP 35 – A representative from Interested Parties gave a summary of the results of its voluntary survey of companies on the application of SSAP 35, Guaranty Funds. The purpose of the survey was to "evaluate the consistency of the application of the current guidance in SSAP 35 and determine whether insurers have been able to comply with the current guidance with some degree of reliability."

The survey revealed that for life and health insurers that the statutory liability as a percentage of direct written premiums was identical to the range of responses for the GAAP liability, which was the expected outcome per the Interested Party report since the SAP and GAAP requirements are essentially the same. However, the same was true for property/casualty insurers, which the survey summary states was not the expected outcome. Interested Parties believe there is not enough information from insolvent companies to estimate a company's share of the future assessments.

As a result of the survey, Interested Parties plan to have a proposal ready for the Summer National Meeting to amend SSAP 35 to reflect that adequate information is not available to comply fully with the current guidance.

Update from the International Statutory Accounting Principles Subgroup – The chair of the subgroup gave a summary of recent activities in the international accounting arena. Several members of the working group acknowledged that they believe NAIC participation during the developmental phase of international accounting standards for insurers is critical for solvency. The NAIC's commitment to this work was demonstrated by the formation of the new International Solvency Initiatives Working Group, which will hold a conference call this spring to educate the SAP Working Group on international accounting issues.

## **Emerging Accounting Issues Working Group**

At its meeting in Orlando, the working group reached a final consensus on the following issue:

Update to INT 03-01: Application of SSAP No. 35 to the Florida Hurricane Catastrophe Fund – The working group amended its tentative consensus on its proposed update to the INT; the working group had revised the guidance in INT 03-01 in December to reflect that the uncollected FHCF assessments are no longer the liability of the insurer. Based on input from Interested Parties, the working group voted to nullify the INT entirely since the FHCF now qualifies as a pass-through entity as discussed in par. 10 of SSAP 35.

The working group then considered outstanding items and reached the following tentative conclusions, which were exposed for comment. Comments on all issues are due to the NAIC by May 15th.

INT 00-26 Amendment Resulting from the Issuance of FAS 153 – The working group voted to expose proposed changes to INT 00-26 to conform the guidance to FAS 153 from the current APB 29 guidance included in the INT.

Accounting for Revenue as a Result of the Sale of Claims Data to a Pharmacy Benefits Manager – The working group reached a tentative consensus that such revenue to health entities should be classified as a reduction of claims expense. The Form B notes that such claims data sold is used for pharmaceutical and medical research purposes and has been "scrubbed" of personal information.

Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) – The working group reached a tentative conclusion that the accounting for investments in CAPCOs should be based on the accounting for the underlying investment, such as bond, common stock, preferred stock, limited partnership, etc. Such guidance is considered necessary since CAPCOs have been excluded from the scope of SSAP 94, as discussed above in the meeting of the SAP Working Group.

Reporting of Litigation Costs Incurred for Lines of Business Where Legal Expenses are the only Insured Peril – This issue was referred to the Casualty Actuarial Task Force.

ETIF 04-6: Accounting for Stripping Costs Incurred during Production in the Mining Industry and EITF 04-13: Accounting for Purchase and Sales of Inventory with the Same Counterparty – The working group reached a tentative conclusion to reject these two FASB EITFs as not applicable to statutory accounting.

Reinsurance of Separable Benefits – At the Winter National Meeting of the Reinsurance Task Force, the task force forwarded a Form B to the working group for its consideration of the credit for reinsurance of separate benefits when certain specific criteria are met. At the request of the trade association sponsor, the Form B was withdrawn. No reason was given for the withdrawal.

## **NAIC/AICPA Working Group**

The NAIC/AICPA Working Group is well into its third year of deliberations on its project to consider the provisions of the Sarbanes Oxley Act of 2002 and additional corporate governance requirements for insurance regulated entities. The working group held a series of conference calls over the last month to discuss comment letters on the re-exposure of the Model Audit Rule (the "MAR") dated December 5, 2005. The proposed changes reflect a compromise between regulators and various interested parties to adopt some of the requirements of Sarbanes-Oxley. At the end of its meeting in Orlando, the working group adopted the final exposure draft with minor changes since the last conference call. This draft was presented by the working group to the Financial Condition (E) Committee, to be considered for adoption. E Committee then voted to expose the Model Audit

Rule for a forty-five day comment period and a public hearing at an interim meeting in May.

The final draft would revise the Model Audit Rule in three significant ways:

- Companies with direct written and assumed premiums of more than \$500 million would be required to annually file a Management Report of Internal Control Over Financial Reporting. (No related audit report would be required.)
- Companies meeting certain premium thresholds would be required to have independent audit committee members, who would also be required to be members of the board of directors. The number of independent members would vary based on premium volume.
- Auditor rotation and independence requirements including scope of services would be revised to conform more closely to the requirements of Sarbanes-Oxley.

The proposed effective dates are years ending December 31, 2008 for the new audit committee requirements and years ending December 31, 2009 for all other requirements.

Following is a brief discussion of the latest deliberations, as well as the development of an Implementation Guide to supplement the MAR and assist companies with implementation of the new requirements.

### Results of Interim Conference Calls

The following summarizes discussion and MAR revisions resulting from the interim conference calls.

*Premium Thresholds for Independent Audit Committee Members* - The working group agreed to increase significantly the premium levels that trigger the requirement for independent audit committee members (whom also must be members of the board of directors). The threshold for a majority (50% or more) of independent audit committee members was raised from \$25 million to \$100 million, and the requirement for a supermajority (75% or more) of independent members was raised from \$100 million to \$300 million. The premium threshold for requesting a hardship exemption from the requirement for

independent audit committee members was raised from \$200,000 for the maximum to \$300,000.

*Communications with Audit Committees* - Section 14F of the proposed MAR was revised to require communication to audit committees by the auditor of all "significant accounting policies and material permitted practices." Previous versions would have required all permitted practices to be communicated to the audit committee.

*Management's Report of Internal Control over Financial Reporting* - The regulators, interested parties and AICPA representatives had significant discussion regarding the requirement to disclose "the approach or processes by which management evaluates the effectiveness of its internal control over financial reporting." The AICPA suggested that "approach or processes" be replaced with "criteria" to improve specificity. Interested Parties objected, and no change was made. However, the following was added as an additional requirement of the Management Report: "[include a] statement that briefly describes the scope of work that is included and whether any internal controls were excluded." In addition, a detailed discussion of internal control approaches will be included in the Implementation Guide as discussed below.

*Communication of Internal Control Related Matters Noted in an Audit* - The working group clarified during its February 16th call that the Communication of Internal Control Related Matters Note in an Audit (Internal Control Report) should be filed with all states in which an insurer is licensed. The December 5, 2005 version of the proposed changes to the MAR had removed the requirement to file the report with non-domiciliary states, which the working group stated was unintended. In addition, the working group has agreed that the Internal Control Report will only include unremediated material weaknesses once the revised requirements become effective, and no change was made to that provision. Until the effective date of the revised MAR, however, insurers will continue to report both unremediated significant deficiencies and unremediated material weaknesses to all states in which they are licensed, as discussed in the AICPA publication *A Statutory Framework for Reporting Significant Deficiencies in Internal Control to Insurance Regulators*.

*Definition of Audit Committee and Group of Insurers* - The definition of audit committee was revised to clarify that an audit committee can

oversee the accounting and financial reporting processes of both an insurer and "group of insurers" to address the operations of multi-tiered holding companies. The working group also agreed to additional wording in the MAR on "insurer or group of insurers" to provide more specificity due to the various ways an insurance entity may be included in its holding company structure. Those definitions can be found in Section 16C.

*Code of ethics* - The working group noted during its February 10 call that no comment letters had been received on the proposed annual statement disclosure related to a company code of ethics. Therefore, the working group adopted a motion to forward the proposed interrogatory to the Blanks Working Group for its consideration at the Summer National Meeting. Disclosure on the company's code of ethics will be included in the Annual Statement General Interrogatories and will ask the following question:

Are the senior officers of the reporting entity subject to a code of ethics which includes the following standards:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. Full, fair, accurate, timely and understandable disclosure in the periodic reports to be filed by the reporting entity;
3. Compliance with applicable governmental laws, rules and regulations;
4. The prompt internal reporting to an appropriate person or persons identified in the code violations of the code; and
5. Accountability for adherence to the code?

#### Development of the Implementation Guide

As discussed above, several issues raised during the comment letter process were deferred, to be addressed in the Implementation Guide. The first draft of the guide will be prepared by Interested Parties, who are preparing a draft to be discussed at an interim meeting of the working group in May. The current list of issues to be addressed by the guide is set forth below.

- Instructions and examples of suggested documentation to demonstrate compliance with the Management Report on Internal Controls

- Clarification and illustration of the "group of insurers" concept for reporting on internal controls
- Guidance on a hardship waiver for audit partner rotation (providing examples on what situations would warrant a waiver) and guidance on transitional issues as a result of changes in audit partner rotation requirements (both of which will be drafted by AICPA representatives)
- Guidance on a hardship waiver for audit committee independence requirements as permitted by Section 14H of the MAR, such as providing examples of when it would be appropriate to provide a waiver.
- Language to encourage companies to file the Section 11 and Section 16 reports concurrent with filing of their audited financial report (as opposed to 60 days later) in years in which a regulatory financial examination is being conducted.
- Guidance on what is meant by "reliability of financial statements" as used in the Section 3 definition of "internal control over financial reporting." The guide will also address the definition of "inherent limitations" of internal control systems, which appears in Section 16D of the MAR.
- Examples of criteria that could be used by management to evaluate internal control over financial reporting. For example, the AICPA's comment letter suggested that the criteria "should be free from bias, permit reasonably consistent qualitative and quantitative measurements of a company's internal control, be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted, and be relevant to an evaluation of internal control over financial reporting."
- Examples of a letter from management to inform the regulator that the insurer has voluntarily complied with the Sarbanes Oxley Act.
- Guidance on which specific senior officers will be required to sign the Management Report on Internal Control.

- Example procedures that would be performed to meet the "diligent inquiry" requirement in Section 16D(2).

Several interested parties objected on several occasions to the adoption of the MAR prior to the completion of the Implementation Guide. The regulators pledged that the final Guide will not create requirements that are not included in the MAR.

#### NCOIL Resolution

The final working group discussion item related to the MAR was a Resolution on the Application of Federal Sarbanes-Oxley Standards to State Insurance Regulators that was adopted by the National Conference of Insurance Regulators (NCOIL) on February 25, 2006. The resolution opposes the adoption of the proposed changes to the MAR discussed herein. NCOIL believes consideration and adoption of such Federal legislation to non-public companies should be authorized by state legislatures and not state insurance departments and the NAIC.

In the spirited debate that followed between members of the working group and a representative of NCOIL, the working group Chairman noted disagreement with many clauses in the NCOIL Resolution, pointing out several inaccuracies, all of which had been communicated to NCOIL prior to adoption. The working group has recommended for some time that the new MAR be adopted by each state through regulation or legislation and not via adoption of changes to the NAIC Annual Statement Instructions. As such, adoption of the NCOIL Resolution may present a significant challenge to the process of adopting the changes to the MAR. At the same time, the working group emphasized that NCOIL does not represent the entire legislature of each state; only one representative from each state is a member of NCOIL. At the conclusion of this discussion, the working group representative from New York stated that its insurance department plans to work through these issues with its own legislature.

#### Status Report on the Recent AICPA Activities

A representative from the AICPA noted that later in March the AICPA will issue the finalized eight risk assessment auditing standards, as detailed below. The AICPA has offered to attend a future NAIC/AICPA Working Group meeting and present key changes in audit practices that are expected to result from issuance of these standards. The



Chairman responded that the working group would welcome such a presentation.

- SAS No. 104, Amendment to Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures* "Due Professional Care in the Performance of Work,"
- SAS No. 105, Amendment to Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*,
- SAS No. 106, *Audit Evidence*,
- SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*,
- SAS No. 108, *Planning and Supervision*,
- SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*,
- SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*,
- SAS No. 111, Amendment to Statement on Auditing Standards No. 39, *Audit Sampling*.

### **P/C Reinsurance Study Group**

The study group discussed the following issues in Orlando.

#### Next Steps in the Review and Development of Risk Transfer Guidance

The study group heard a brief presentation from a representative of the American Academy of Actuaries, which has formed a Risk Transfer Work Group to complete a white paper for the study group. The work group has members from actuarial consulting firms, accounting firms, insurance companies and a representative from the New York Insurance Department.

The chair of the Risk Transfer Work Group provided a Draft Outline of Issues to Address, which includes three broad categories: 1) safe harbors and definition of when risk transfer is "reasonably self-evident," 2) technical issues in risk transfer testing and 3) risk transfer testing

issues regarding data, methods and interpreting results.

Under the category of "technical issues to address" are included the following items:

- How to determine the appropriate interest rate to be used for discounting
- How to treat a guaranteed interest rate on funds held or experience account, i.e. is this additional premium?
- Does "cash flows" mean cash that has changed hands or does it also include implied cash flows?
- Consideration of brokerage fees
- Consideration of commutation clauses, sunset clauses, special termination provisions, and special cancellation rights
- Consideration of ceding commissions paid in the future or at contract expiration
- What are the components of the numerator and denominator in a test for significant of loss to the reinsurer?

Under the category of risk transfer testing issues regarding data, the work group will discuss data considerations for modeling the subject business, how should process risk, parameter risk and model risk be considered and what kinds of methods such as Value at Risk, Tail Value at Risk, Expected Reinsurer Deficit and Relative Risk testing work with specific type of contracts and features.

The study group will consider this white paper, which is expected to be completed by August, in enhancing the current risk transfer guidance in SSAP 62. The chair also noted that the study group will also continue to monitor the bifurcation proposals being discussed by FASB and fair value accounting being discussed by the IASB.

#### Multi-Cedant Reinsurance Issues

The study group discussed comments received from the New Jersey and Nebraska Insurance Departments during the public exposure period related to the issue on multi-cedant reinsurance, in which several ceding companies enter into a reinsurance agreement with one or more assuming reinsurers. Based on the discussion, the study group directed NAIC staff to draft an amendment to SSAP 62 to require that such reinsurance agreements include a written allocation agreement

and that the allocation be "fair and reasonable." Once adopted by the study group, the proposal will be forwarded to the SAP Working Group for their consideration.

Accounting for Excess Ceding Commissions - This issue of the requirement to defer ceding commissions received in excess of acquisition costs incurred has been on the study group's agenda for several years. At the meeting in Orlando, the study group reached a final conclusion not to change how the liability for excess ceding commissions is calculated under paragraph 51 of SSAP 62. However, the study group member from Wisconsin will work with NAIC staff to draft language for SSAP 62 to clarify the amortization period for the liability, and this approach was supported by the study group.

#### Debrief on New Finite Reinsurance Disclosures and Attestation

The chair of the task force solicited comments from both industry and regulators on suggestions to clarify the instructions for the reinsurance disclosures and attestation and whether the information was "clear and useful" to the regulators. The chair noted that the New York Department received very few questions from companies and has questioned whether there was a consistent understanding of the requirements.

### **Capital Adequacy Task Force**

The task force met in February via conference call to adopt the underwriting risk factors for Medicare Part D Prescription Drug Coverage that had previously exposed for comment. This factors will be effective for 2006 RBC filings. For underwriting risk, the initial factor of 0.141 will be used for the first \$25 million of premium and 0.109 for premiums over \$25 million. Managed credit factors are 0.5 for risk-corridor protection and when there is both risk-correction protection and reinsurance a credit of .065 is used.

The task force then heard a report from the C-3 Phase II Results Subgroup, which has the charge of conducting a detailed analysis of the C-3 Phase II calculation in order to make recommendations to the task force for potential changes to the formula or instructions. The American Academy of Actuaries is in the process of conducting and compiling a detailed survey for companies to

complete that asks what aspects of compliance were the most difficult and whether the company plans to incorporate C-3 Phase II methodology in internal business practices. Results of the survey will be discussed at future meetings.

The task force then heard an update of the Catastrophe Risk Charge Subgroup from the chair of the P/C RBC Working Group; the working group began discussing last year the appropriate treatment of catastrophe risk in the P/C RBC formula. The chair reported that the subgroup is at the early stages of its work but has identified two areas for which they have asked assistance from the Academy: what catastrophe risk charges are included in capital requirements in other countries and those calculated by rating agencies, and a recommended procedure to extract the catastrophe loss and premium out of the current RBC calculation to minimize double counting of catastrophe exposure. No timetable was given for completion of this work.

### **Life Risk-Based Capital Working Group**

#### Expansion of C-3 Phase I

The working group is moving forward rather quickly with a proposal to expand C-3 Phase I interest testing to apply to all companies except for small companies with assets less than \$100 million. Under current RBC requirements, only companies that fail one of two tests regarding interest rate risk or capital levels are required to do the C-3 Phase I cash flow testing. The intent of working group is to pass this requirement in June in order for it to be effective for 2006. A conference call will be scheduled before the Summer National Meeting to discuss any comments to the current exposure draft. Once again, the ACLI asked regulators what problems they are seeing that they are trying to address with this additional requirement; no regulator provided an example of specific problems that have been identified.

#### ModCo Dividend Liability

The Academy provided a partial recommendation regarding the appropriate way to treat dividend liabilities under Life RBC calculations. The Academy recommended that a company should be allowed the dividend liability credit in the RBC calculations as long as the company's financial results can be affected by changes in the dividend scale. They also recommended a specific actuarial certification for this calculation. The remainder of the Academy's analysis, that dealing with Closed Blocks, will be provided in June. The

working group will hold a conference call to discuss the Academy's recommendation.

#### C-3 Phase II Update

The working group plans to modify the Life RBC instructions for 2006 and needs to complete the recommendations by the Summer National Meeting to accomplish this. Suggestions should be sent to Philip Barlow of the DC Insurance Department. A conference call will be scheduled prior to June.

#### C-3 Phase III

A brief report was made indicating that work has commenced on a life insurance version of the C-3 stochastic analysis requirements that currently apply only to annuity products.

### **P/C Risk-Based Capital Working Group**

The working group did not meet in Orlando but met via conference call on February 8 and discussed workers compensation large deductible exposures and a possible exemption for mono-line bail bond companies from RBC. The risk with respect to large deductible policies is that they now compose a larger share of the market, which can expose the insurer to significant credit risk. With regard to the mono-line bail bond companies, there is concern that the RBC formula does not appropriately reflect the risk of that business and should perhaps be exempted from RBC similar to mono-line financial guaranty and mortgage guaranty companies.

On both issues the working group concluded they should wait for the results of work from other NAIC groups. The Casualty Actuarial Task Force is reviewing the need for additional financial reporting requirements for large deductible workers' compensation policies and the SAP Working Group is developing uniform accounting for bail bond business.

### **Valuation of Securities Task Force**

Since the 2005 Winter National meeting, the task force met via conference call for three meetings. The following summarizes significant conclusions reached and the current status of issues being deliberated by the task force:

#### Principal Protected Notes (PPNs)

During its November 14th conference call, the task force agreed to expose for a 60-day comment period an issue paper that would require that

principal protected notes be reported at amortized cost unless considered other-than-temporarily impaired. At its interim conference calls, the task force discussed concerns on the issue paper related to:

- The chair of the task force (New York) discussed that an Issue Paper is not needed; rather SSAP 43 can be amended to include impairment guidance.
- The chair discussed that the use of undiscounted cash flows in an other-than-temporary impairment analysis is not appropriate.
- Interested Persons discussed that the Issue Paper should only be applied to structured securities which contain principal protection mechanisms intended to assure the repayment of principal.
- The task force agreed that over-collateralization does not constitute principal protection and to add a sentence to this effect at the end of the first paragraph of the Discussion section.

At the Spring National Meeting, the task force again discussed these issues at length and did not reach a decision. However, interested parties agreed to prepare examples of why the impairment approach applied to bonds with respect to the use of implicit discounted cash flows is not appropriate for principle protected notes; the NAIC staff was directed to prepare a position paper on why the use of discounted cash flows in an impairment analysis of PPNs is preferable; NAIC staff will also prepare a position paper on how SSAP 43 can be amended to include impairment guidance for PPNs, rather than the issuance of a new SSAP.

#### Summary by Country/Supplemental Investment Risk Categories

The task force discussed a request from the Investment Schedules Subgroup of the Blanks Working Group for guidance on whether the Summary by Country and the Supplemental Investment Risk Interrogatories should require disclosure of investment risk related to foreign investments based upon the "issue" (i.e. country of issue) or the "issuer" (specific company issue). No decision was made. NAIC staff believe that exposure to sovereign risk (i.e. "issue") is the

greater risk. The task force will focus in future meetings whether to recommend adoption of the definition of foreign securities that is included in the Defined Limits version of Investment of Insurers Model, although they recognize this may require significant system changes for insurers.

#### Short-term and Cash Equivalent Bonds

The task force discussed a request from the Investment Schedules Subgroup for clarification on how short-term and cash equivalent bonds should be reported in the Annual Statement Schedule D-Part 1A and the Quarterly Statement Schedule D-Part 1B. The task force recommended that the disclosure of such instruments on Schedule D summary schedules be eliminated. The task force also suggested two possible approaches to resolving the Schedule D Part 1 A and B issues: either segregate Schedule DA assets as a separate line in each bond category or remove the Schedule DA assets from the summary schedule.

#### Administrative Symbol for SCAs

The task force adopted a request from the Investment Schedules Subgroup that separate indicators be developed and used for SCA entities where the price was analytically determined by (1) the Securities Valuation Office, or (2) by other than the SVO.

#### Derivative Instruments Model Regulation

The task force approved a recommendation from the NAIC staff to study whether the model regulation for derivative instruments should be revised due to an increased use and complexity of derivatives used in the current marketplace. The chair noted that the SVO has hired a very experienced economist that will be working on this project. The chair also suggested that a Derivatives Use Plan approach similar to those adopted in New York and California be considered in the review.

#### Approval of A.M. Best as an NRSRO

After months of discussion, some of which was contentious, the task force agreed to add A.M. Best to the NAIC NRSRO List.

### **International Accounting Standards Working Group**

At its meeting in Orlando, the working group discussed the following issues.

#### Insurance Contracts Phase II Developments

The working group heard an update on the status of the Insurance Contracts Phase II project at the International Accounting Standards Board (IASB). Specifically, it was discussed that the IASB has:

- Generally agreed that "policyholder renewal expectations" is an asset, but should only be considered as some form of a customer relationship intangible.
- Generally did not support that insurance liabilities should be based on their current entry value (versus their exit value); however no decision was made.
- Unanimously agreed that a pre-claims "stand ready obligation" on non-life business should be based on a prospective model (in certain cases, the unearned premium model may be considered a prospective method).

#### IAIS Insurance Contracts Subcommittee

The subcommittee of the International Association of Insurance Supervisors issued its first paper on Liabilities in June of 2005. The subcommittee is currently working on its next paper which will cover the nature of risk margins, the treatment of premium flows on long-term insurance contracts, embedded derivatives, and discretionary participation features. Members of the working group and interested parties were requested to provide comments to the NAIC so that these comments can be discussed at the next subcommittee meeting. There are three main areas of debate regarding the treatment of long-term premium flows: (1) negative liabilities, (2) surrender values, and (3) acquisition costs. A draft of the second liabilities paper will be submitted to other NAIC groups (Actuarial Task Forces, International Solvency Working Group, etc.) for comments prior to finalizing the paper.

#### IASB Discussion Papers

The IASB previously released two Discussion Papers for comment: (1) Management Commentary, and (2) Measurement Bases for Financial Reporting - Measurement on Initial Recognition. At the Spring National Meeting, the working group decided that the NAIC should draft a comment letter on the Discussion Paper on Measurement on Initial Recognition and would not draft a comment letter on the Discussion Paper on Management Commentary. A conference call will be scheduled during the interim for the working group to discuss the draft letter.

#### IASB/FASB Memorandum of Understanding

On February 27, 2006, the Financial Accounting Standards Board and the IASB reaffirmed their commitment to the international convergence of accounting standards by releasing a memorandum entitled *A Roadmap for Convergence between IFRSs and US GAAP—2006-2008*. The memorandum discusses the Boards' goals through the year 2008, such as short-term goals for convergence, and discusses other joint projects that the Boards are undertaking.

#### Fair Value Option Exposure Draft

The working group was informed that the FASB released an exposure draft as part of their convergence project with the IASB that would give entities the option to measure certain financial assets and financial liabilities at fair value. The working group agreed to assist the Statutory Accounting Principles Working Group in deciding whether to comment on the exposure draft.

### **Risk Assessment Working Group**

The working group heard reports from two of its subgroups:

#### Report from Risk Assessment Handbook Revisions Subgroup

The subgroup provided a status update of its work. The specific items addressed included the following:

*Confidentiality* – The NAIC Model Law on Examinations provides specific guidelines regarding the confidentiality of information developed, received or disclosed. The subgroup believes that these guidelines should also be applicable to Risk Assessments prepared by management.

*Small/Medium Company Approach* – Comments have been received inquiring as to whether the risk-focused approach would be applicable to small/medium-size companies and whether the previous "SRA (specific risk analysis) Approach" could be used. The subgroup believes that the fundamental elements of the risk assessment process should be completed for small/medium-size companies under a risk-focused approach.

*Coordination with the NAIC/AICPA Working Group* – Constituents recommended that the Risk Assessment Working Group coordinate with the NAIC/AICPA Working Group to consider the "internal control assessment" provisions of the

NAIC Model Audit Rule in the risk assessment process.

*Evaluation of Prospective Risks/Assessment of Procedures Outside Financial Reporting* – One of the main reasons for a risk-focused approach is to allow the examiner to complete examinations on the financial condition of the insurer. The subgroup believes that a prospective assessment is an intrinsic process throughout the risk-focused assessment process and should be considered a fundamental element of the examination.

*Utilization and Placement of Management Comment Letters* – The subgroup believes that the contents of a Management Comment Letter should be determined by each respective insurance department. The Comment Letter document is issued by the examiner outside of the Report of Examination to convey comments or concerns to the company so that the examiners would have the ability to provide comments they did not feel warranted inclusion in the Report of Examination.

*Training/Risk Assessment Examples/Examiner Mindset* – The NAIC is committed to provide comprehensive training to regulators on the revised risk-focused approach.

The Handbook Revisions Subgroup will hold an open interim meeting on March 20 in Chicago to provide an opportunity for interested parties and regulators to discuss the revisions proposed. Both parties have been asked to review the revised Handbook guidance and submit questions or discussion topics to NAIC Staff by March 14.

#### Report from the Risk Assessment Implementation Subgroup

The subgroup provided a status update of its work and discussed its four proposed conclusions and recommendations pertaining to accreditation issues and transition towards the revised risk-focused Handbook. The four conclusions/recommendations include:

- The revisions are significant for accreditation purposes;
- A waiver of procedures to the accreditation process should not be pursued to accelerate the accreditation timeline to require use of the revised risk-focused surveillance process;
- For the transition phase to the use of the revised risk-focused approach, states may

elect to utilize the approach as soon as the approach is initially adopted by the Risk Assessment Working Group, the Financial Condition Committee, and Executive and Plenary; and

- Inclusion of the risk-focused surveillance process within the NAIC Financial Condition Examiners Handbook Manual will occur in the 2007 publication release.

In addition, the subgroup will propose revisions to the accreditation review team guidelines in response to the revised risk-focused Handbook.

#### Other Matters

The working group was advised that the risk-focused surveillance guidance included within the NAIC *Financial Condition Examiners Handbook* will be formally presented to the Risk Assessment Working Group shortly after the subgroup's open interim meeting. Upon receipt of this guidance, it is anticipated that the working group will expose the Handbook guidance for a 30-day exposure for new comments only. The working group will consider any new comments received during the interim, thus allowing the working group to consider adoption of the revised Handbook guidance during the Summer National Meeting. (The revised Handbook, although not officially exposed, is currently available on the NAIC website.)

### **Financial Regulation Standards and Accreditation Committee**

At the Spring National Meeting, the Committee agreed to incorporate revisions to the following:

- NAIC Financial Condition Examiners Handbook
- Annual Statement Blanks and Instructions
- Life and Property & Casualty Risk Based Capital Formulas
- Purposes & Procedures Manual of the Securities Valuation Office
- NAIC Accounting Practices and Procedures Manual

Furthermore, the committee discussed changes to the following NAIC guidance and whether such revised requirements should be considered required Accreditation Standards:

#### Insurer Receivership Model Act

The committee received an update on the status of the recommendation from the Financial Condition (E) Committee related to the completely revised Insurer Receivership Model Act adopted at the Winter National Meeting. The referral regarding this Model Act is expected to be forwarded to the committee by the Summer National Meeting.

#### 2001 Revisions to the Model Regulation Requiring Annual Audited Financial Reports

The committee adopted the 2001 revisions to the Model Regulation Requiring Annual Audited Financial Reports into the Accreditation Standards. These revisions prohibit the use of indemnification clauses by independent certified public accountants regarding an audit of an insurer. The use of mediation or arbitration clauses would remain available.

#### Proposed Revisions to the Definition of a Multi-State Insurer

The committee adopted revisions to the Part A and Part B Review Team Guidelines Preambles to clarify the definition of a multi-state insurer. The revisions define a multi-state company as one that is licensed and/or operating in more than one state.

#### Model Act and Regulation on Custodial Agreements and Use of Clearing Corporations

The Committee discussed the elements of the Model Act and Regulation that should be considered significant when deciding whether the law should be required for accreditation. The following were the specific items considered significant: definition of clearing corporation, requirements for custodian records, requirement that securities be deposited with clearing corporations under control of the State Insurance Commissioner, definition of custodian and tangible net worth, requirements for the custodial agreement, and requirements for deposits with affiliates. The Committee is expected to discuss these items further and consider the Model Act for accreditation at the 2007 Spring National Meeting.

#### Referral from Financial Examination Modernization Working Group

The Committee received recommended revisions to the Review Team Guidelines related to the statutory examination requirements when coordinated examinations are conducted, statutory examination requirements when companies are under some sort of insurance department supervision, definitions for full and limited scope

examinations and calculation of examination timeliness statistics from the Financial Examination Modernization Working Group. The committee agreed to expose the recommended revisions for a 30-day comment period.

### **Tax Policy Task Force**

The task force met in Orlando and continued its discussion of tax issues affecting the insurance industry; its charge is to advise Executive Committee on whether the NAIC should take a position on insurance tax issues. The meetings continue to be educational and "fact-finding" for members of the task force. No conclusions were reached but the task force discussed the following issues:

- President's Advisory Panel on Federal Tax Reform, which is focusing on the tax free "build up" in life insurance and annuity products
- Tax issues related to ongoing efforts to develop a catastrophe plan
- Tax issues related to health insurance such as the deductibility of health insurance premiums and health savings accounts, and
- Federal tax exemption for state workers' compensation funds that write business outside their primary state.

### **Class Action Litigation Working Group**

The working group discussed matters related to insurance class actions and how they affect insurance regulators. The working group heard a report from the NAIC staff related to progress on the study being conducted by the RAND Institute for Civil Justice related to the effect of class action litigation on insurance regulation and the NAIC efforts to draft a white paper on the topic. The RAND study is complete and is currently undergoing peer review. The study should be available before the Summer National Meeting.

The working group then heard from several interested parties regarding recent class action activity and the impact of the FAIR Act of 2005 on class actions. The working group discussed whether to draft a model law to address either primary jurisdiction or exclusive jurisdiction issues and the exhaustion of administrative remedies doctrine. No decisions were made, however the working group generally agreed that application of any of these doctrines would require legislation rather than the application of common law.

Consumer representatives further discussed the possibility of allowing consumers to express themselves in administrative hearings would minimize the number of cases that ultimately are certified as class actions.

### **Blanks Working Group**

The working group adopted 18 blanks proposals and exposed 9 new items for comment. The comment period ends May 11, 2006. The adopted proposals include the following, which are effective for year-end 2006 unless other stated.

- Modification to the Notes to Financial Statements to include new disclosure requirements of SSAP 90, *Accounting for Impairment or Disposal of Real Estate Investments, Discontinued Operations*
- Modification to Schedule BA and AVR to add lines to account for the SSAP 93 low income housing tax credits by categories
- Instructions to clarify how Paid-in Surplus should be reported in the capital and surplus account and that paid-in surplus should only change when issued stock increases or decreases; it is effective the first quarter of 2007.
- Modification to Schedule S - Ceded Reinsurance to include new columns for effective date and type of reinsurance ceded; it is effective the first quarter of 2007.
- Clarification on the classification of unrestricted collateral used for securities lending transactions; the working group concluded that if the collateral is cash, then it is included in cash. If the collateral is bond, then it is classified with bonds. A write-in line should not be used. The proposal is effective the first quarter of 2007.
- Adding guidance on the reporting of a gain or loss on the disposal of fixed assets.
- Instructions to clarify as to what is expected to be reported under Note 1 of the Financial Statements with regard to state practices that differ from NAIC prescribed. The instructions clarify that the note is required in the annual statement even when there are no differences.

- Modification to Note 12 to incorporate the requirements of FASB SFAS 132R (additional pension disclosures) as adopted by the SAP Working Group.
- Modification to Schedule Y instructions to provide specific guidance where an entity is 50% owned by two parties, such as providing a footnote of any voting rights preferences that one of the entities may have; it is effective the first quarter of 2007.

The working group deferred consideration of three proposals until the Summer National Meeting. Under the working group's revised procedures, proposals may only be deferred twice, before being removed from its agenda. One of the deferred proposals would modify Schedule P Interrogatories to include additional disclosures for extra contractual obligations by line of business. The proposal stems from INT 03-17: *Classification of Liabilities from Extra Contractual Obligation Lawsuits*, which is discussed in the summary of the SAP Working Group above.

The working group also rejected one blanks proposal which would have required write-ins on Combined P&C Blanks to be reported in detail rather than as a single write-in line.

The working group received reports from the Investment Schedules Subgroup, the P&C Lines of Business Subgroup and the newly formed Schedule T Subgroup. The Investment Schedules Subgroup continues to consider proposals which affect the investment schedules of the annual statement blank and provide recommendations to the working group and the SVO Task Force. The P&C Lines of Business Subgroup is considering classification issues related to certain insurance product offerings. The Schedule T Subgroup reported that it is charged with considering appropriate methods for allocating premiums by state and to develop the necessary instructions. The subgroup will be soliciting information from life insurance and annuity writers to identify the current approaches being utilized.

All Blanks proposals, both adopted and exposed for comment, can be viewed at the NAIC's webpage for the Blanks Working Group.

## Consumer Protections Working Group

The working group discussed the following current projects outstanding:

### Effectiveness of Disclosures

The working group developed a subgroup to develop minimum guidelines for the development, assessment, and implementation of effective disclosures.

### Consumer Alerts

The working group reviewed consumer alerts that have been recently issued by the NAIC on identity theft, winter weather and insurance, and Medicare prescription drug coverage. Additionally, the working group discussed a recommendation that consumers be educated on Medicare Part D and the cost of average health care in future alerts.

### Outreach to State Consumer Service Representatives

The working group discussed the need for a collaborative effort with the state consumer services representatives. Specifically, the working group decided to inquire of these representatives what additional issues require review and to provide them training as to the consumer issues regarding insurance.

### Other Matters

The working group discussed that there has been issues with the Consumer Information Source (CIS). The Complaints Handling and Reporting Standards (D) Working Group was established to review CIS and address the issues. Additionally, consumer representatives asked the working group to review the NAIC "buyer's guides" to determine whether these guides need to be updated.

## Life Insurance and Annuities (A) Committee

At the beginning of the meeting, the chair recognized New York as a new member of the committee.

### Amendment to Senior Protections in Annuity Transactions Model Regulation

The committee unanimously adopted changes to the model regulation to remove the age threshold of 65 years old. As a result the model regulation



applies to all consumers who are considering the purchase of annuity products "so that the insurance needs and financial objectives are appropriately addressed." The model has now been renamed Suitability in Annuity Transactions Model Regulation.

#### Amendment to Life Insurance and Annuities Replacement Model Regulation

Based on work performed by the Inter-Affiliate Term Conversion Working Group, the committee voted to approve revisions to the model regulation to add an exemption to the model's requirements for term conversions between affiliates. The model currently provided such an exemption for intra-company term conversions, i.e. when the same insurer converts a term policy to another type of insurance policy during the life of the term policy.

#### Report from LHATF

During the report on the activities of the Life and Health Actuarial Task Force in Orlando, the committee asked the status of LHATF's project on its "long-term principles-based proposal" on life insurance reserving. The chair of LHATF from New Mexico stated that the process has recently encountered a "hiccup" in reaching consensus. The A Committee chair re-emphasized the importance of the project and that if the task force cannot reach a long-term solution by its original timetable, then an interim solution must be considered such as the approval of preferred risk mortality tables, and revisions of lapse rates. When asked if LHATF would meet its timetable, its chair responded in the affirmative.

#### Interim meeting

The chair announced that the committee will hold an interim public meeting in May in New York to address life settlements, premium financing, expansion of the insurable interest concept and other issues. The meeting details will be posted to the NAIC's website when finalized.

#### Joint Meeting with Market Regulation & Consumer Affairs (D) Committee

After its regular National meeting, the committee held a lengthy joint meeting with D Committee to address what changes should be made to existing NAIC models as a result of the growth in the indexed products market. The committees heard presentations from the Iowa Insurance Division and an industry representative. The Iowa Division suggested that the NAIC consider amending four NAIC models and enhanced training for producers and insurance department staff. A representative

for the Center for Economic Justice asked what recent events with respect to indexed products necessitate such a large project. Regulators responded that it is an opportune time to revisit the issues. The committees then went into closed session and no conclusions reached by the commissioners have become available.

### **Life and Health Actuarial Task Force (LHATF)**

#### Update on Life RBC C-3 Phase II Work and VA Reserves

At the Winter National Meeting, LHATF voted to expose for comments a new version of Actuarial Guideline ("AG") VACARVM that incorporated the then current exposed version of the AG dated April 29<sup>th</sup> with relatively minor changes suggested by the American Academy of Actuaries ("Academy") in their August 10<sup>th</sup> report, and the ACLI's suggestions on the standard scenario. At that meeting, proposals from the New York Insurance Department were narrowly rejected by LHATF. Much has changed since that December meeting.

During a January conference call on this subject, LHATF voted to replace the exposed version of AG VACARVM with New York's proposal, virtually the same version of the guideline that they had rejected a little more than a month earlier. During this meeting in Orlando, New York further entrenched itself as the driver of this initiative for LHATF. By the end of the discussions, LHATF members and interested parties were urged to call New York regulators directly with any comments and suggestions they have on the new exposed AG VACARVM.

The Academy gave its report which disclosed four major objections to New York's proposal. Firstly, the Academy believes that reserve levels set at 75 CTE as proposed by NY are excessive. This essentially produces reserves that are adequate at the 90<sup>th</sup> percentile. In addition, since reserves are a pre-tax calculation, the Academy believes that 75 CTE reserves in many cases will exceed the RBC requirements for these products because the RBC calculations, although calculated using 90 CTE, are after-tax.

The Academy also believes that the revenue sharing provisions in the current NY proposal are too restrictive as are the requirements regarding policyholder behavior assumptions. In addition, the Academy still has strong objections to the standard scenario including the use of a separate

option value floor. While the Academy said it can support the concept of a standard scenario floor, they believe that this calculation should be more simplified than currently proposed and that it truly be a minimal floor and not the driver for reserve levels.

Several interested parties had various comments. A common remark centered on the fact that reserve requirements need to be calculated quarterly (in contrast to RBC which is an annual requirement) and that the increase in required actuarial resources to meet the current proposed reserve requirements would be significant.

Representatives from New York appeared to be pushing to get AG VACARVM adopted by LHATF in June so that it will be effective for year-end 2006. LHATF's charge is to complete this by September 2006. Two conference calls will be scheduled prior to the Summer National Meeting. Recognizing that the calls will attract a large number of interested parties, LHATF suggested anyone with comments to contact New York regulators who will be responsible for reviewing any comments or suggestions.

#### Interim Proposals Relative to New Valuation Standards from ACLI

At the Winter National Meeting, the ACLI made a presentation regarding additional life insurance reserve changes based on the compromise proposed by CEOs from 10 companies last year to resolve the AG 38 issue. Their proposal is intended to bridge the revisions to AG 38 that LHATF completed last year and the longer term principles-based solution. At this meeting, the ACLI presentation focused on two recommendations: (1) the application of lapse rates in reserve formulas for calculating reserves for secondary guarantees only, and (2) the ability of the NAIC to adopt a revised mortality table containing multiple preferred underwriting classes that was developed from theoretical assumptions and not from actual mortality data.

With regard to allowing lapse rates in the AG 38 calculations for the secondary guarantees only, there appeared to be no support from any member of LHATF. However, the issue was not voted on, so it is still under consideration. With regard to the theoretical mortality table, LHATF suggested asking the Society of Actuaries to look at the proposed tables and provide input to LHATF. However, no formal request of the Society was

made. LHATF agreed to discuss this issue in a future conference call.

#### Update on an Interim Table for Preferred and Standard Mortality Classes from Joint SOA-AAA Project Oversight Task Force

A report was made by the joint task force updating LHATF on the progress of developing a new valuation mortality table which will include multiple preferred underwriting categories. One of the purposes of the new table is to support the needs of what is expected to be required by principles-based reserve standards. The task force expects to complete their study in early 2007. It is not known at this time whether the results of their efforts will be a completely new valuation table or factors to be applied to the 2001 CSO table. To date, 49 companies have contributed their data to the study. The task force is currently reviewing the various underwriting criteria used by the different companies submitting data to the study.

#### Report from the Academy's SVL2 Work Group

A status report was presented from the Academy's SVL2 Work Group covering a number of areas involving the overall principles-based reserving project. The primary focus was on review and governance. The Academy presented a high level framework on the role of a Principles-Based reviewer and solicited feedback from LHATF. The Academy believes that the reviewer should evaluate the actuary's work and focus on the judgments used by the actuary in setting assumptions. There was some discussion regarding who would hire the reviewer: the company or the regulator. Also discussed was the timing of the reviewer's report. Most regulators favored having the reviewer complete his or her work by or shortly after the filing of a company's annual statement. Two conference calls will be scheduled prior to the Summer National Meeting in order for LHATF to provide feedback to the Academy.

#### AAA Life Reserves Work Group

The Academy made a presentation regarding their work on principles-based reserve requirements for life insurance products. A major part of their presentation consisted of comparing reserve levels for a typical 20-year level term product. The Academy's work clearly demonstrated that current formulaic reserves, using 2001 CSO mortality, were significantly higher than conservatively calculated reserves under a principles-based approach.

Regulators from New York presented marked up versions of the three proposed Actuarial Guidelines that the Academy presented at the last meeting. Few regulators had any questions regarding NY's proposed changes. The Academy did not have sufficient time to study all of these suggestions, but noted that they had concerns regarding aggregation and the discount rate proposed by New York. Also discussed was whether any changes to the valuation requirements would be prospective only or would cover existing in-force business. A decision on this controversial topic does not appear to be imminent.

#### Report from the Academy's Non-forfeiture Improvement Work Group

The Academy provided a brief verbal report on their work to study possible revisions to the standard non-forfeiture law in order to make available a broad array of more flexible and consumer-oriented policy designs. The Academy is working on a white paper on this subject that they hope to have available for the Summer National Meeting. An interested party enlivened the discussion with a somewhat hypothetical example of how life settlement companies are taking advantage of differences between the real economic value in the life insurance contract and the policy's cash value. Some regulators remarked that they feel they are being put in the middle between policyholders, insurance companies and life settlement companies.

#### Reinsurance Reserve Credit

This item, not on the published agenda, is a concern of the California Insurance Department. The issue involves the ceding on a coinsurance basis, where the coinsurance premiums are paid annually, of a block of term insurance business where premiums are paid more frequently than annually. Typically, the business in question has net premiums that exceed gross premiums. Under some companies' interpretations of the NAIC Accounting Practices and Procedures Manual, the direct company sets up a net deferred premium asset that is greater than the annual gross premiums ceded to the reinsurer, thereby creating a temporary increase in surplus. California is proposing changes to SSAP 51, SSAP 61 and Appendix A-791 to clarify the correct treatment for this situation. California is asking LHATF to recommend these changes. LHATF voted to expose California's proposal for 45 days, to be followed by a conference call to discuss. If LHATF agrees with California's proposal, they will send

their recommendation to the Statutory Accounting Principles Working Group.

#### AG ABC

With very little discussion, LHATF adopted AG ABC, Projection of Guaranteed Non-forfeiture Benefits under CARVM. This guideline deals with how to apply the new individual deferred annuity non-forfeiture requirements when calculating reserves under CARVM.

#### Revisions to Modal Variable Annuity Regulation

Also with little discussion, LHATF adopted revisions to the Variable Annuity Model regulation in order to bring this model in line with the annuity standard non-forfeiture law.

#### Study of Feasibility of Electronic Filings of all Actuarial Certifications

Regulators are considering requiring all actuarial certifications, including certifications required by Actuarial Guidelines and other regulatory reporting requirements, to be submitted electronically. One of the issues surrounding this proposal is that some of these certifications are confidential.

#### Report on SOA Pre-need Mortality Experience Study

The Society of Actuaries did not have a formal report. Progress towards a new pre-need mortality table is being made. The Society expects to present a data analysis report to LHATF in June.

### **Accident and Health Working Group**

#### LTC Experience Forms Revisions

The working group adopted changes to the LTC Experience Reports and instructions that it had exposed for comment at the Winter National Meeting and sent the recommended changes to the Blanks Working Group for their approval. There was an issue raised by the ACLI regarding the applicability of these experience reports to accelerated benefits provided under life insurance contracts. ACLI asked that there be an explicit exemption of life insurance accelerated benefits from this reporting requirement because the forms were not developed to include these types of LTC benefits. However, the A&H Working Group did not agree on the explicit exemption and agreed that the current exemption in the instructions would likely apply to most accelerated benefits under life insurance contracts. New York regulators noted that they will most likely require additional information from insurers licensed in its state.

#### Premium Deficiency Reserves

Little progress was reported by a subgroup that was formed to study the need for premium deficiency reserves for health insurance. Like the previous subgroup that studied this issue, this subgroup is having difficulty forming a consensus. Members of the subgroup are optimistic that progress will be made by the Summer National Meeting; however, they acknowledged that they may disband and wait for the accident and health version of principles-based reserves to address this issue.

#### Alternatives to Individual Medical Rate Regulation

No progress was reported on this longstanding issue regarding rate spiraling that occurs on closed blocks of individual medical business. Two conference calls will be conducted before the Summer National Meeting to move this project along.

#### Accounting for Prepaid Loss and Claims Adjustment Expenses

This is an issue related to INT 02-21, Accounting for Prepaid Loss Adjustment Expenses and Claim Adjustment Expenses, which exempts managed care companies from the guidance in that interpretation. Managed care companies were exempted because of certain language in the Health Reserve Guidance Manual. The working group agreed that the reserve guidance manual language needs to be corrected and that INT 02-21 should apply to managed care companies.

### **Reinsurance Task Force**

#### Proposed Finite Reinsurance Attestation for Life Insurance Companies

The task force briefly review the three comment letters received from trade associations and a life insurer related to the proposal presented at the Winter National Meeting that would require CEOs and CFOs of life insurance companies to sign an attestation identical to the attestation now required for P/C companies, except that the reference is changed from SSAP 62 to SSAP 61.

All the comment letters objected to the attestation being applied to life insurers because those responding believe that the requirement would be unnecessary since risk transfer requirements for life insurance are already very well specified under SSAP 61 and Appendix A-791. The task force member from New York agreed that the current requirements are quite clear; however, the New York Department would like senior officers to attest

that those requirements are being followed. New York asked that additional discussion be deferred until the Department completes its internal analysis of life reinsurance contracts that have been filed with New York in the past and the extent to which the Department deemed there was inadequate risk transfer. The task force agreed to defer resolution until a future meeting.

#### Cut-through Endorsements

The task force discussed a referral from the Financial Regulation and Accreditation (F) Committee to consider cut-through endorsements, which allow payments for losses to other than the receiver in an insolvency. The task force had asked in December that its interested party group review the issue and provide input. In Orlando, a representative from interested parties reported that 39 states have laws that expressly allow such cut-through policy endorsements. Members of the task force questioned which solvency and/or examination issues are the concerns of F Committee as a result of the cut-throughs and agreed to go back to the committee for additional clarification.

#### Proposal to Add Financial Conglomerates to the NAIC Bank List

The task force exposed a proposal in December to add "highly capitalized financial conglomerates" to Part 10 of the SVO's Purposes and Procedures Manual for approving banks that meet certain credit standards. After discussion in Orlando, the task force deferred action so that NAIC staff can confirm whether such conglomerates are regulated the same way as banks that are approved to issue LOCs. NAIC staff will be looking at the regulation of financial services groups by the SEC, OTS and the Federal Reserve.

#### Amendment to the Reinsurance Intermediary Model Act

The working group unanimously adopted proposed amendments to the Reinsurance Intermediary Model Act which are meant to improve the arbitration process for resolving disputes between ceding and assuming companies. The amendments add a new section to the model act entitled Compliance with Orders and specify that a reinsurance intermediary broker or manager must comply with court orders that require the production of non-privileged documents or testimony of an employee.

### Revision of the Credit for Reinsurance Model Regulation

After a brief discussion the task force adopted revisions to the Credit for Reinsurance Model Regulation that are considered unnecessary and potentially in conflict with Section 304 of the U.S. Bankruptcy Code. The amendments were made to Section 10(b)(14), which provides the procedures for administering the assets of single beneficiary trusts. The task force noted that no comments were received during the exposure period.

### New Charge for the Task Force

In connection with the task force's completion of its U.S. Reinsurance Collateral White Paper, which was adopted by the Commissioners at their Executive and Plenary sessions in Orlando, the task force was given a new charge by Executive Committee to start the next phase of this project. That charge is as follows:

The Reinsurance Task Force is directed to develop alternatives to the current reinsurance regulatory framework, including the use of collateral with the U.S. and abroad. Consider approaches that account for a reinsurer's financial strength regardless of domicile, i.e. state or country. Identify and consider variations in state law and regulation relative to reinsurance contracts, financial reporting, etc. As part of its deliberations, the task force should consult with international regulators, in addition to all other interested parties. The task force shall present the proposal to the membership by the 2006 Winter National Meeting.

During the discussion of the new charge, the task force noted that all parties should come to the table with the sincere goal of discussing the issues in good faith. The task force recognizes that the marketplace has changed since the current collateral requirements were drafted and workable alternatives must be developed.

### **Casualty Actuarial Task Force**

The task force adopted a Blanks Working Group proposal to modify the Statement of Actuarial Opinion Exhibits and to require electronic data submission of the data in the exhibits. The Blanks Working Group will consider this proposal at a future meeting. Submission of the document (in .pdf format) continues to be required.

The task force established a subgroup to develop comments about the proposal to add a warranty

line of business to the Blank as made by a subgroup of the Blanks Working Group. This subgroup will also review a request made by the Nebraska Commissioner for the task force to consider supporting modification to standards that apply to the actuarial certification of reserves held by insurers that underwrite motor vehicle service contracts (or service contracts in general).

The task force discussed that it will meet jointly via conference call this spring with the Statutory Accounting Principles Working Group to discuss possible changes to the working group's extra contractual disclosure proposal made to the Blanks Working Group.

The task force received status updates provided by the following subgroups:

- The Workers' Compensation Large Deductible Subgroup is working with the American Academy of Actuaries and the National Council on Compensation Insurance (NCCI). A proposal is anticipated for the next conference call, with potential action to be taken at the Summer National Meeting to address referrals from the *Workers' Compensation Large Deductible Study*.
- The Extended Loss and Loss Adjustment Expense Reserves Subgroup addressing tail coverages asked whether its charge should be limited to financial reporting issues or whether it should also include the impact on pricing as well as other areas. Members of the task force seemed to support a broader charge and requested the subgroup to recommend a detailed scope for discussion at the next conference call.
- The Intercompany Pooling Subgroup is investigating the increased use of 100% pooling where the ceding entity receives 0% of the pool. The impact of this pooling arrangement is the elimination of Schedule P reporting for the ceding insurer. The subgroup will seek input from the Statutory Accounting Principles Working Group.
- A newly formed subgroup to evaluate the potential role of the actuary in the enhanced risk-focused surveillance process will begin work with the AAA later this month.

The task force stated that it will continue to monitor the Casualty Actuarial Society's work related to their *Report on the Credibility of the Actuary*.

## **Risk Retention Group Task Force**

The task force continued its discussion of the APP Manual accreditation standard which states that an accredited insurance department should require all insurers reporting to the department to file the appropriate NAIC annual statement blank prepared in accordance with the NAIC *Accounting Practices and Procedures Manual*. The issue is how this standard should be applied to various risk retention groups.

The task force summarized previous discussions noting that the primary unresolved issue related to this standard that requires the use of statutory accounting is that captive risk retention groups (RRGs) are typically permitted or required by their state of domicile to utilize GAAP for financial reporting purposes, including the use of GAAP when filing the NAIC annual statement blank. It was discussed that the AP&P Manual allows a Department to prescribe or permit accounting practices that differ from statutory accounting as long as a reconciliation is included in Note 1 of the annual statement. Previously, it had been discussed whether it is acceptable for a Department to prescribe GAAP accounting as long as a reconciliation was included. A referral has been sent to the Statutory Accounting Principles Working Group but a formal response will not be received until the Summer National Meeting. The task force tentatively agreed that a Department may prescribe accounting standards that differ from SAP, including GAAP, but that a reconciliation in notes to the financial statements would be required.

Additionally, because of the use of GAAP a Department would need to perform procedures in addition to those included in the *Financial Condition Examiners Handbook* (Examiners Handbook) to ensure that all items are adequately examined. The task force tentatively discussed how these additional procedures could be documented, such as a supplement to the Examiners Handbook.

The task force also discussed the accreditation standard regarding valuation of investments. As the task force has already tentatively agreed that use of GAAP is acceptable, it would accordingly be acceptable that investments are not necessarily valued in accordance with the AP&P Manual. The task force also noted that various items within the SVO Purposes & Procedures Manual might be

beneficial, even in situations in which the AP&P Manual is not followed.

## **Risk Retention Working Group**

The working group discussed the need for additional disclosures to address concerns raised in the Government Accountability Office's (GAO) report on the Liability Risk Retention Act. The GAO's concern is that risk retention group members may not fully understand and appreciate the lack of guaranty fund protection. The working group reviewed proposed language submitted by interested parties. Members of the working group generally supported the proposed language with slight modification; however before approving it, the working group requested that the language be presented on a sample disclosure notice to be reviewed at a future meeting.

## **Financial Examination Modernization Working Group**

The working group continued discussion of exceptions to the 18-month timeliness accreditation standard, which generally requires a report of examination must be filed no later than 18 months after the "as of" date. The working group exposed a revised draft of proposed exceptions for a 45-day public comment period.

The working group began discussions of its new charge to review and recommend guidance regarding to what extent, if any, non-lead states in a multi-state examination must review the examination procedures completed by the designated lead state or coordinating states and the extent to which this review and/or reliance should be documented within each state's examination workpapers. The working group reviewed a draft recommendation prepared by NAIC Staff and discussed various points that would need to be considered. The working group will conduct a conference call during the spring to continue discussion on this topic.

## **Financial Examiners Handbook Technical Group**

At its meeting in Orlando, the technical group adopted an examiner request log that will provide state examiners a record when information requests are made, the agreed-upon due dates for response and when a complete and adequate response is received from the insurer. In addition,

they also agreed to expose revisions to the NAIC Financial Condition Examiners Handbook in response to the final implementation rules of USA PATRIOT ACT that require all insurers who sell or underwrite certain products to have anti-money laundering programs.

### **Advisory Organization Examination Protocol Working Group**

The working group discussed and clarified the direction it will take to establish a protocol for conducting examinations of the statistical agent functions of advisory organizations such as ISO and NCCI. Advisory groups provide market data which insurers use to set rates. The regulators want to insure the quality and accuracy of this data as errors could result in inappropriate premiums for the level of risk assumed.

Members concluded that there are two efforts which should be undertaken to help states be better equipped to conduct examinations of these entities. The first is to expand the Statistical Agent section of the Market Conduct Examination Handbook to make it more useful for states to evaluate the insurer data reporting and statistical agent data collection processes, data quality, and the integrity of the statistical data systems which are utilized for rate development.

The second effort is to establish an efficient cost-sharing procedure using Market Conduct Examination guidelines for conducting multi-state examinations of these entities. The working group determined that it should initially focus on the Statistical Agent section of the Handbook and that it will invite the three states (Georgia, New York and Florida) that regularly conduct statistical agent exams to provide an overview of their exam process at an upcoming meeting.

### **Disaster Reporting Working Group**

The working group was formed by the Financial Condition Committee at the Winter National Meeting to develop a framework for state insurance departments to coordinate disaster reporting efforts by state insurance departments.

Members of the working group discussed recent coordinated disaster reporting efforts resulting from the 2004 and 2005 hurricane seasons. The working group received a report prepared by the NAIC staff regarding the confidentiality protection

applicable to data collected in a coordinated disaster reporting system.

The working group requested that interest parties provide comment letters regarding the coordinated disaster reporting initiative to NAIC staff no later than April 7, 2006. The working group heard initial comments from a few interested parties who expressed concern regarding the frequency of reporting which had been required by insurance commissioners related to hurricane damage claims. There was additional concern regarding sharing of confidential data between state insurance departments and the NAIC.

### **National Treatment and Coordination Working Group**

The working group discussed the development of uniform definitions of licensing categories to be included in the Company Licensing Model Act. Once finalized and if adopted by individual state legislatures, companies which write business in multiple states would be able to apply for the same license in each state. Current licensing requirements vary significantly by state. The licenses would be mapped to certain lines of business as defined in the statutory annual statement.

The working group discussed whether a few broad licensing categories should be developed (e.g., property, general casualty, etc.), or whether the categories should be more specific, perhaps at the line of business level. Members favoring the broader category approach agreed to provide several documents that link these categories to the annual statement lines of business and identify the various lines of business currently utilized by states for company licensing purposes. The working group will consider these documents during a future conference call.

Industry trade representatives agreed to help the working group by identifying other industries that are subject to state licensure and describe the uniform licensing approach utilized in those industries.

The working group reviewed comments received on an exposure document regarding how to handle existing state issued certificates of authority if uniform licensing categories are adopted in the Company Licensing Model Act. Based upon the comments received, the working group agreed that the Act should provide for the issuance of new

certificates of authority once the licensing category definitions are adopted by a state.

The working group noted that a shell outline of the Company Licensing Model Act that includes the various components required in the Uniform Certificate of Authority (UCAA) primary and expansion applications will be reviewed on a future conference call. This review will help the working group to consider all components and their interaction, giving more clarity to the direction that should be pursued in tackling the specific issues of the Act.

### **Market Conduct Annual Statement Working Group**

The working group did not meet in Orlando. However, the working group does plan on meeting via a conference call, to be scheduled, to discuss its 2006 charges, the 2005 statement filing process, and to review industry comments.

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The next National Meeting of the NAIC will be held in Washington D.C. on June 10-13, 2006. We welcome your comments regarding issues raised in this newsletter. Please give your comments or email address changes to your PricewaterhouseCoopers LLP engagement team, or directly to the NAIC

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### **Disclaimer**

Since a variety of viewpoints and issues are discussed at task force and committee meetings taking place at the NAIC meetings, and because not all task forces and committees provide copies of agenda material to industry observers at the meetings, it is often difficult to characterize all of the conclusions reached. The items included in this Newsletter may differ from the formal task force or committee meeting minutes. In addition, the NAIC operates through a hierarchy of subcommittees, task forces and committees. Decisions of a task force may be modified or overturned at a later meeting of the appropriate higher-level committee. Although we make every effort to accurately report the results of meetings we observe and to follow issues through to their conclusion at senior committee level, no assurance can be given that the items reported on in this Newsletter represent the ultimate decisions of the NAIC. Final actions of the NAIC are taken only by the entire membership of the NAIC meeting in Plenary session.