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NAIC REGULATORY UPDATE

This tri-annual issue of the NAIC Regulatory Update summarizes the National Association of Insurance Commissioners' financial activities affecting health entities at the 2010 Summer National Meeting. The meeting took place August 13-17, 2010 in Seattle, WA.

NAIC Hot Topics

The Health RBC Working Group adopted final changes to the 2010 Health RBC formula and instructions.....[see page 1](#)

The Capital Adequacy (E) Task Force received a report of the 2009 RBC data from NAIC staff.....[see page 1](#)

The Blanks Working Group adopted nine blanks proposals during their June conference call and three additional blanks proposals at the summer meeting.....[see page 3](#)

The Statutory Accounting Principles Working Group adopted nonsubstantive changes to the *Accounting Practices and Procedures Manual*.....[see page 4](#)

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The Valuation of Securities (E) Task Force adopted several revisions to the *SVO Purposes and Procedures Manual*.....[see page 7](#)

The NAIC/AICPA Working Group decided not to pursue a blanks proposal that would require a reporting entity to disclose in a General Interrogatory its audit committee members and their independence....[see page 11](#)

The Examination Oversight (E) Task Force updated the results of a survey to track states' progress in adopting revisions to the "Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition.".....[see page 12](#)

The Financial Examiners Coordination Working Group adopted a new Examination Coordination Framework for inclusion in the NAIC Financial Condition Examiners Handbook...[see page 12](#)

The Financial Condition (E) Committee voted to form the Health Reform Solvency Impact (E) Subgroup...[see page 12](#)

Financial Regulation—Risk-Based Capital

The **Health Risk-Based Capital (E) Working Group** adopted final changes to the 2010 Health RBC formula and instructions. The 2010 changes consist of the following items:

1. Adopted a proposal modify a reference for page XR006 Off-Balance Sheet Collateral. Schedule DL, Part I was added to the year end 2010 annual statement to capture any collateral within a security lending agreement the reporting entity has reported on page 2, line 10 of the asset page. Page XR006 title was modified to indicate that this schedule should include those securities reported in Schedule DL, Part I. In addition, the instructions were modified to say:
For Year-end 2010, Annual Statement Schedule DL, Part I, Securities Lending Collateral Assets reported On-Balance Sheet (Assets Page, Line 10) should be included on the schedule with the Off-Balance Sheet Collateral.
2. A new derivatives line was added to the annual statement assets and liabilities pages that were previously reported in the aggregate write-ins. As a result, a new line for derivatives was added to page XR007 Fixed Income Assets with a risk factor of 5%.
3. Implemented an incremental change to the Medicare Part D supplemental benefit factor reported on page XR014 Underwriting Risk – Other Line 22.1. The new factor for year-end 2010 is 35%, up from 21% for year-end 2009.
4. Adopted a proposal adding a deferred tax asset (DTA) sensitivity test. The new sensitivity test measures total adjusted capital with and without the impact of the incremental DTA resulting from the new provisions in SSAP No. 10R – Income Taxes. It also shows the RBC ratio without the incremental DTA to provide regulators with a review tool for those companies that are below the trend test level but do not trigger the trend test action level.

The **Working Group** also discussed how the Patient Protection and Affordable Care Act (the "Act") may impact the RBC formulas. The Working Group discussed how the Act could potentially impact the solvency of insurers and concluded that monitoring RBC results and additional analysis of the current factors within the underwriting risk section of the RBC formula is warranted. The Working Group believes that the rebates could negatively impact insurers operating results by lessening their opportunity to recover losses. The Working Group believes that no specific recommendations can be made until the U.S. Department of Health and Human Services finalizes the guidelines regarding the rebates.

The **Capital Adequacy (E) Task Force** received a report of the 2009 RBC data from NAIC staff. The report reflects a decrease in the number of Life and P&C companies that triggered an RBC action level and a slight increase in the number of Health companies for the 2009 annual statement filings.

Financial Regulation—Risk-Based Capital

Annual Statement Year Ending As of December 2008 and 2009, Respectively						
	Health		Life		P&C	
	12/31/08	12/31/09	12/31/08	12/31/09	12/31/08	12/31/09
Percentage of Companies with Action Levels	5.8%	5.9%	3.0%	2.2%	3.2%	2.5%
Companies with action levels:	47	47	25	18	84	67
Trigger Trend Test	N/A		4	2	25*	33*
Company Action Level	23	27	6	3	28	18
Regulatory Action Level	6	11	5	3	16	10
Authorized Control Level	3	1	3	2	9	10
Mandatory Control Level	15	8	7	8	31	29

The **Task Force** also heard a report from the American Academy of Actuaries (AAA) regarding its project on to review the treatment of deferred tax assets (DTA) in the three RBC formulas. The AAA findings propose that there is no RBC charge for well capitalized companies if the current SSAP No. 10R limitations are maintained, as there is an implicit RBC charge resulting from the nonadmission charge found in the SSAP. The AAA further concluded that weakly capitalized companies should still be subject to the 100% RBC charge. The Task Force exposed the AAA report for comments until September 15.

The **Task Force** also heard a report from the **Solvency Modernization Initiative RBC Subgroup**. The Subgroup was formed to perform an evaluation of the RBC formulas, factors and methodologies, to calibrate the formulas and recommend a timeline for implementation of any changes that are adopted. The major item discussed was on calibrating the current RBC formulas, based on the “calibrating the ‘X%’ probability that an insurance company has enough resources to meet its obligations over an ‘N’ year horizon.” In addition to the calibration discussion, the Subgroup also discussed:

- Missing risks that should be quantified in RBC;
- Identification of risk quantification that should be improved, using modeling where factor-based approaches are not sufficient to capture the identified risk; and
- Prioritization of projects.

Financial Reporting

In a joint Executive Committee/Plenary session the NAIC Executive Committee gave its final approval on a new Supplemental Health Care Exhibit (the “SHCE”) that will be filed with the 2010 annual statement. The new Supplement was developed to assist regulators and the Department of Health and Human Services (HHS) in identifying and analyzing the medical loss ratio (MLR) as required in Section 2718 of the Public Health Service Act (PHSA), as amended by section 1001 of the Patient Protection and Affordable Care Act (PPACA). Section 2718, sets out a methodology for calculating medical loss ratios and for determining when and in what amount insurers must pay rebates to their enrollees if their medical loss ratios do not meet statutory standards. Section 2718(c) specifically charged the NAIC with the task of defining the terms used in the medical loss ratio formula and establishing the methodology used for computing it.

The new Supplemental Health Care Exhibit is due by April 1, 2011 based on the reporting entity’s 2010 operating results; however the MLR will not impact the rebate until the 2012 submission of the 2011 results. As a result it is ex-

Financial Reporting, continued

pected that further revisions will be made to the Supplement based on the MLR submissions in 2011.

The **Blanks Working Group** adopted nine blanks proposals during their June conference call and three additional blanks proposals at the Summer NAIC National Meeting affecting the Health, Life, Title and Property/Casualty Blank forms and instructions.

The **Working Group** adopted the following the following changes to the 2010 Health Annual Statement and 2011 Quarterly Statements:

Item	Effective Date
Combined the current grouping of sub-categories used for mortgage-backed and asset-backed securities from the current five groupings into three sub-groupings for the appropriate Schedule D, DA and E schedules.	Quarterly 2011
Expanded the list of identifiers used for "Other Asset Backed Securities" in Schedule D Part I Column 26 – Collateral Type.	Annual 2010
Added two columns to Schedule S, Part 4 (Life, Fraternal and Health); Schedule F, Part 5 (Property) and Schedule F, Part 3 (Title) to identify the bank issuing or confirming a letter of credit. The new columns will capture the banks American Bankers Association (ABA) routing number and name.	Annual 2011
Modified the annual statement instructions to the Actuarial Opinion to add several exemptions in which the actuarial opinion is not required. The modified instructions also clarify some items that have to be opined on and the required wording if there are different reserve requirement in several states.	Annual 2010
Added a supplement to the property and casualty supplement to capture premium and loss data related to Director and Officer Insurance.	Quarterly 2011
Added new barcode identifiers for a new supplemental exhibit for Analysis of Annuity Operations by Line of Business and Analysis of Increase in Annuity Reserves During the Year. These barcodes will only be used by Life and Fraternal Insurers.	Annual 2010
Added a new instruction and illustration to Note 5E for repurchase agreements. The proposal also adds a new interrogatory to be included in the General Interrogatories, Part I, and adds a new code to the investment code list for reinvested collateral from securities lending programs.	Annual 2010
Added a new Schedule DL, Securities Lending Collateral Assets. Schedule DL will be used to report reinvested collateral assets at the end of each quarter.	Annual 2010
Added a new line to the asset page (Securities Lending Reinvested Collateral Restricted Asset) and a new line to the liability page (Payable for Securities Lending).	Annual 2010
Added illustrations to the instructions for Note 9, Income Taxes. The amounts for 9A and 9C will be electronically data captured in the electronic notes.	Annual 2010

The **Working Group** also exposed five proposals for comment. The following four proposals affect the Health statement:

- I. Proposal to add a new question to General Interrogatories Part I regarding letters of credit unrelated to reinsurance. The interrogatory would capture the American Bankers Association (ABA) routing number, issuing or confirming bank's name and the circumstances where the letter of credit might be triggered. The proposed change would be effective for the 2011 Annual Statement.

Financial Reporting, continued

2. Proposal to add a new General Interrogatory in Part I that captures the asset and liabilities duration using five different interest rate scenarios. In addition this proposal adds a new column to Schedule D, Part I and Part 2, Section I for reporting a Modified Duration for each bond and preferred stock owned. The proposed change would be effective for the 2011 Annual Statement.
3. Proposal to modify the definition of “All Other Governments” in the Investment General Instructions to include bonds issued by corporate entities that are fully guaranteed by non-US governments. The proposed change would be effective for the 2011 Annual Statement.
4. Proposal to add a new code “B” to the Foreign Code matrix in the Investment General Instructions. The new code would be used for Canadian securities issued in a foreign country but denominated in U.S. dollars. The proposed change would be effective for the 2011 Annual Statement.

The comment deadline for the above exposed items is September 17, 2010.

The **Working Group** also adopted a revision to its Procedures in connection with procedures for addressing amendments to the annual and quarterly statements. The revision will allow the **Working Group** to accept new agenda items during the annual June conference call instead of only considering adoption of items presented at the Spring NAIC National Meeting. Thus three meetings will be held during the NAIC Spring, Summer, and Fall National Meetings and a full fourth meeting will be held via conference call in June of each year. Other conference calls may also be held if deemed necessary by the **Working Group**.

Financial Regulation—Accounting

The **Statutory Accounting Principles Working Group** adopted the following nonsubstantive changes to the *Accounting Practices and Procedures Manual* during the Summer National Meeting:

1. Ref No. 2010-02 – **Clarification of SSAP No. 90 – Accounting for Impairment or Disposal of Real Estate Investments, Paragraph 6**

Adopted revisions to SSAP No. 90 to clarify that “properties occupied by the company” are subject to the recoverability testing when “any” of the conditions in paragraph 6 are met. The revisions clarify confusion on whether properties occupied by the company were subject to recoverability testing if any, and not “all” of the conditions in paragraph 6 were met.

2. Ref No. 2010-05 – **ASU 2010-06, Fair Value Measurements and Disclosures**

Adopted revisions to SSAP No. 100 – *Fair Value Measurements* to adopt with modifications, the new and revised disclosure requirements from ASU 2010-06 – *Fair Value Measurements – Improving Disclosures About Fair Value Measurements*. The revisions to SSAP No. 100 specify which fair value measurements are considered recurring or nonrecurring and also included adoption of a wording clarification.

The Working Group modified its exposed guidance on the determination of which investments will be considered valued at fair value on a recurring basis. Consequently the following was added to footnote I and paragraphs 55 and 57 to SSAP 100:

For purposes of statutory accounting, investments that are consistently measured at fair value shall be disclosed as securities “measured at fair value on a recurring basis.” The term “consistently measured at fair value” includes, but is not limited to, securities reported at the lower of cost or fair value based on NAIC designation regardless if the security was reported in the previous period at amortized cost.

The disclosures are effective for 12/31/2010 financial statements and thereafter.

3. Ref No. 2008-14 – **Revisions to Address Measurement of Sufficient Collateralization for Securities Lending Transactions**

A recommendation was received from the Securities Lending Subgroup to expose substantive revisions to SSAP

Financial Regulation—Accounting, continued

No. 91R - *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* during the NAIC Spring National Meeting. The revisions to SSAP No. 91R uses a modified GAAP approach of defining what is on and off balance sheet assets; this will require that if the collateral can be sold or pledged by custom or contract by the company, it will be considered “on” the balance sheet. The revisions also require additional disclosures and will be reported on a separate line of the balance sheet.

During a conference call in May, the Working Group adopted the proposed revisions to SSAP 91R that provide a modified GAAP approach of defining what is on and off balance sheet. The new guidance requires the uses of the new schedule, Schedule DL, for reporting securities lending transactions.

In addition to the changes adopted to the *Accounting Practices and Procedures Manual* the **Working Group** took the following actions:

1. Ref No. 2006-30 – **Draft SSAP - Accounting for Pensions and SSAP No. 92 – Accounting for Postretirement Benefits Other Than Pensions**

The Working Group exposed SSAPs for pensions and OPEB with new transition guidance that moved the effective date from 2010 to 2011 and extended the transition guidance to 10 years. The guidance adopts, with some modifications, FAS 158/ASC 715. The comment deadline for these SSAPs is October 1.

2. DTA Subgroup - **SSAP No. 10R – Income Taxes, Revised**

At the 2010 NAIC Spring National Meeting, the Working Group formed the DTA Subgroup to research and monitor changes to SSAP No. 10R - *Income Taxes, Revised* and to provide updates to the Working Group on the impact the changes will have on the financial reporting of insurers. At the Summer National Meeting, the Subgroup reported on its progress including the following:

During May, the subgroup approved a data call requesting more detail from insurers on deferred tax assets. The subgroup then held an educational session on DTAs for regulators where the Subgroup heard presentations from representatives of industry, the AICPA and the AAA and also received a preliminary report from NAIC staff on the results of the data call.

The focus of the industry presentation was on how DTAs originate and reverse; grouping of DTAs for measurement and the statutory valuation allowance. The AICPA's presentation discussed the auditing of income taxes, including audit risk, procedures, and documentation. The AICPA representatives discussed the four possible sources of taxable income including tax planning strategies. An extended discussion then ensued of the use of such strategies and how they affect the determination of admitted DTAs.

Regulators expressed concern that a significant admitted DTA can be recognized with the use of tax planning strategies only. The AICPA representatives pointed out that tax planning strategies must be prudent and feasible, supported by documentation, must reflect the cost to apply the strategies, and cannot be contradictory to other assumptions made by the company.

Lastly, the Subgroup heard a presentation from a representative of the AAA on the preliminary findings of the project requested by the Capital Adequacy Task Force to review the treatment of DTAs in all three RBC formulas. The study's findings propose that there be no RBC charge for well capitalized companies if the current SSAP 10R limitations are maintained, as there is an "implicit" RBC charge from the nonadmission requirement. The Academy also agrees that weakly capitalized companies should still be subject to the 100% RBC charge.

Based on the update, the Subgroup voted to expose for comment until August 27 a one year extension of SSAP 10R until December 31, 2011, with a proposed additional disclosure related to tax planning strategies. A joint conference call of the Working Group, the Accounting Practices and Procedures Task Force and the Financial Condition Committee was scheduled for September 8 to consider adoption of the changes to SSAP 10R.

Financial Regulation—Accounting, continued**3. Rating Agency Working Group Referral**

The Working Group discussed a referral to from the Rating Agency Working Group to "analyze whether it is appropriate to continue using changes in NAIC designations to determine if realized capital gains or losses are to be classified as interest rate gains or losses." The Working Group directed NAIC staff to draft a Form A for the Working Group to consider.

4. Ref No. 2003-12 – Issue Paper No. 135 – Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Direct Guarantees of Others

At the 2010 NAIC Spring Meeting revisions were exposed to SSAP No. 5R - *Liabilities, Contingencies and Impairments of Assets* that added an exclusion for 100% wholly owned subsidiaries from the liability recognition. The proposal also modified paragraphs 16f and 16g by excluding guarantees made on behalf of wholly-owned subsidiary and intercompany and related party guarantees that are considered “unlimited,” respectively. Proposed changes to paragraph 17 clarified the exclusion of a wholly owned subsidiaries and unlimited guarantees from the initial liability recognition requirement.

During the Summer National Meeting, the Working Group continued its discussion on the proposed revisions by addressing a proposal from Interested Parties to replace the liability recognition requirement with expanded disclosures. Consequently the Working Group voted not to revise the previously exposed guidance but did defer the effective date from year-end 2010 to year-end 2011. In addition, an illustration to the disclosure requirement for paragraphs 27a and 28 were added to SSAP No. 5R. Based on these decisions, SSAP No. 5R and 25R were re-exposed for comments with the comment period ending September 16.

5. Ref No. 2010-12 – Clarify Definitions of Loan-Backed and Structured Securities

The Working Group exposed for comment a proposed revision to SSAP 43R - *Loan-Backed and Structured Securities* regarding the definition of loan-backed securities as proposed by the New York Department of Insurance. The following sentence is proposed to be added to the definition (among other changes): "Examples of loan backed securities include, but are not limited to, pass-through securities, lease-back securities and equipment trust certificates." Interested Parties believe this is a substantive change to the definition. The comment period ends September 16.

6. Ref No. 2010-08 – Policy Statement on Coordination with Valuation Manual

The Working Group re-exposed a policy statement on coordination with the Valuation Manual for inclusion within Appendix F of the Accounting Practices and Procedures Manual. The Valuation Manual sets forth the minimum reserve and related requirements pursuant to the Standard Valuation Law.

Comments from interested parties noted that the policy statement would not require input from the SAP Working Group for "changes which are non-substantive or which provide purely actuarial guidance and do not have an accounting impact" as determined by the Life and Health Actuarial Task Force. The Working Group voted to expose for comment deletion of the above guidance and also sent a referral to LHATF requesting the same change in the Valuation Manual. The comment period ends on September 16.

7. Ref No. 2010-03 – Accounting Standards Update 2009-14: Certain Revenue Arrangements That Include Software Elements

The Working Group voted to expose for comment the adoption of guidance on SSAP No. 16R – *Electronic Data Processing Equipment and Accounting for Software* regarding guidance on “software” included in other SSAPs. The proposed revisions included guidance from ASU 2010-14, *Certain Revenue Arrangements That Include Software Elements*. Interested parties commented that they do not believe such arrangements are common among insurers.

8. Ref No. 2010-13 – Accounting for Derivative Instruments and Hedging Activities

The Working Group exposed for comment a proposed revision to paragraph. 21.e of SSAP 86 - *Derivatives*, to change the term "hedged items" to "related financial assets or liabilities." The Working Group rejected other guid-

Financial Regulation—Accounting, continued

ance from ASU 2010-08 such as using the GAAP terms of “noncontrolling interest” or “noncontrolling shareholder” to replace “minor ownership interest” within SSAPs 48 and 97.

The **Emerging Accounting Issues Working Group** rejected a number of items as not applicable to statutory accounting. The Working Group took the following action on other issues:

1. Adopted revisions to ten Emerging Accounting Interpretations (INTs) that have not been updated since substantive and nonsubstantive changes to the related Statement of Statutory Accounting Principle (SSAP) were made.
2. Voted not to finalize INT 07-05T: EITF 06-10, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements as the Working Group does not believe the guidance is necessary since issues of control and ownership of such contracts are now included in SSAP 21 - Other Admitted Assets.
3. Discussed a request from the Connecticut Insurance Department to develop illustrations for reporting of intercompany pooling transactions. The Department believes that in practice, some companies are presenting the unsettled intercompany reinsurance amounts on a net basis (where no right of offset exists) and/or classifying amounts in non-reinsurance accounts, including receivables from/payable to parents, subsidiaries and affiliates. As a result, they believe that unsettled intercompany reinsurance amounts are being inaccurately and/or inconsistently reported within some reporting entities’ balance sheet and or reinsurance schedules.

The Working Group directed NAIC staff to work with Connecticut to develop an illustration for discussion at the 2011 Spring National Meeting.

Financial Regulation—Investments

The **Valuation of Securities (E) Task Force** adopted several revisions to the *SVO Purposes and Procedures Manual* which will be incorporated into the December 2010 Manual.

The **Task Force** adopted modified language to the *SVO Purposes and Procedures Manual* on securities that are considered exempt. When the Manual was reformatted at the end of 2009 and the Appendices were moved to different sections of the Manual some of the text was inadvertently left out and changed the meaning of the definition of exempt securities. The modified language in Part Six, Section 2(e) is as follows:

(e) List of Securities that are Considered “Exempt Obligations” for Purposes of Determining the Asset Valuation Reserve and the Risk-Based Capital Calculation

THIS SECTION IS USED TO DETERMINE THOSE SECURITIES THAT ARE INCLUDED IN THE “EXEMPT OBLIGATIONS” CATEGORY FOR PURPOSES OF DETERMINING ASSET VALUATION RESERVE AND THE RISK-BASED CAPITAL CALCULATION.

For purposes of determining the Asset Valuation Reserve, Risk-Based Capital, and certain other defined regulatory purposes, the issuers and securities shown in Part Two Section #4 (d) (i), (ii) and (iii) are considered to be in the “exempt obligations” category for purposes of determining Asset Valuation Reserve and the Risk-Based Capital calculation although the following exceptions exist relative to mortgage backed/asset-backed securities. Mortgage-backed/asset-backed securities of the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Federal Agriculture Mortgage Corporation (Farmer Mac) and the Federal Home Loan Banks (FHL Banks) are not “exempt obligations”, and shall be reported in the Special Revenue and Special Assessment Obligations category, not in the U.S. Government category.

The only loan-backed and structured securities that are “exempt obligations” and are reported in the U.S. Government category are securities that have a full guarantee for their interest and principal payments by the United States Government, and whose collateral is not divided into separate classes. Examples of such securities are the pass-through securities guaranteed by the Government National Mortgage Association (GNMA) or the U.S. Department of Veterans Affairs (VA). As the

Financial Regulation—Investments, continued

Collateralized Mortgage Obligations (CMOs) divide the collateral cashflows into separate classes (tranches), they are not 'exempt obligations' and shall be reported in the Special Revenue and Special Assessment Obligations category of the Annual Statement, not in the U.S. Government category.

The **Task Force** also adopted revised language in Part I, Section 5(c) Prohibition on Use of NAIC designations in a Covenant. The *SVO Purposes and Procedures Manual* prohibits insurers from inserting clauses in their private loan agreements with borrowers that call for an adjustment in the terms of a transaction upon a change in an NAIC Designation assigned by the SVO. The prohibition does not address NAIC ARO ratings which are converted into NAIC designations by virtue of the filing exempt process. The revised Part I, Section 5(c) addresses the issue by releasing any legal obligation of the SVO as a result of changes in investments' financial terms because of deterioration of NAIC Designations as follows:

*Section 5. NAIC Policies Pertaining to SVO Work Product
(c) Prohibition on Use of NAIC Designation in a Covenant*

An insurance company shall not use:

An NAIC Designation assigned by the SVO, or

An upgrade or downgrade of an NAIC Designation previously assigned by the SVO, or

A change in any aspect of how a security is regulated that is the direct or indirect result of an upgrade or downgrade of an NAIC Designation assigned by the SVO, as the basis for an agreement to modify the terms of a transaction (the "Prohibition").

The Prohibition shall apply only to transactions entered into on or after September 1, 2010. Effective September 1, 2010, insurance companies shall certify to the SVO that the submitted transaction does not contain a prohibited clause or agreement as a condition to filing with the SVO. The SVO is prohibited from processing any transaction it knows or has reason to believe contains a prohibited agreement or clause.

The Prohibition reflects:

The conclusion of the Valuation of Securities (E) Task Force, as the initial and primary NAIC regulatory group responsible for implementing NAIC policy on risk assessment of insurer-owned securities, that the use of NAIC Designations as indicated in the Prohibition to modify the terms of a security or any other transaction is inconsistent with regulatory objectives; and

The decision of the NAIC Executive (EX) Committee, as the body charged with directing NAIC corporate activities, that the use of NAIC Designations as indicated in the Prohibition to modify the terms of a security is inconsistent with the corporate objectives of the NAIC.

Insurance companies are, therefore, advised that the NAIC disclaims any and all responsibility whatsoever for surveillance of insurance company investments for purposes of identifying when a deterioration of the borrower's credit quality or other risk attribute suggests that the insurance company should adjust the financial terms of the original transaction to obtain a different overall investment return or compensation for the risks involved. It is the sense of the NAIC that these decisions are private and the proper and exclusive concern of insurance company management. NAIC Designations are not published as investment advice to insurance companies and might lack necessary attributes that would make them suitable for use as investment advice. The NAIC, therefore, rejects the view that insurance company representatives may reasonably rely on SVO credit assessments or on any other NAIC analytical process as a guide to adjusting the terms of their private investment arrangements with borrowers.

The **Task Force** adopted revised language in Part Two, Section 4(e) pertaining to filing exemption. Since the NAIC has determined that residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) NAIC designation will be determined using financial modeling instead of credit ratings assigned by NAIC AROs, these type of securities are limited to the exemption of filing with the SVO. The revised language excludes RMBS and CMBS from the filing exempt rule in Part Two, Section 4(e) and creates a new filing exemption section for RMBS and CMBS in Part Two, Section 4(f). The new Section 4(f) indicates:

Financial Regulation—Investments, continued

- RMBS and CMBS securities that can be financially modeled are exempt from filing with the SVO.
- RMBS and CMBS that cannot be financially modeled by are rated by an ARO are exempt from filing with the SVO.
- RMBS and CMBS that cannot be financially modeled and are not rated by an ARO are not filing exempt and must be filed with the SVO.

The **Task Force** exposed two revisions to the *Purposes and Procedures Manual*.

- I. Revision on Structured Securities - Proposed amendments to Part Three, Section 3 of the *Purposes and Procedures Manual* address the recent policy and methodology changes adopted by the NAIC for securitizations such as residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). The recommendations are:
 - a. Eliminate all Phase 1 – 3 mechanisms. With the exception of permitting the conversion of NAIC acceptable rating organization (ARO) credit ratings for structured securities into NAIC designations, already addressed by the filing exempt (FE) rule, these instructions have outlived their historical usefulness. These instructions also conflict with existing interim instructions for RMBS and with already adopted policy decisions to change the methodology used to determine NAIC designations for CMBS and potentially for asset-backed securities (ABS).
 - b. Retain the methodology and rules for credit-enhanced securities collateralized by loans.
 - c. Adopt a new textual framework to accommodate policy decisions made by the Task Force relative to RMBS and CMBS.
 - d. Draft additional text related to transactions that have long been under the auspices of the structured transactions group to increase transparency for these populations.

The modifications also add securities backed by auto loans and leases, credit card receivables, manufactured housing student loans, small business stranded costs, equipment leases and loans, aircraft leases, trade receivables, dealer floor plan loans, legal settlements and royalties in the definition of an Asset Backed Security. In addition the modification would add credit tenant loans as part of the definition of CMBS.

2. Filing Exemption for Certificates of Deposit issued by NAIC ARO Rated Banks – Certificates of Deposit that have a maturity date in excess of one year from the date of acquisition meet the definition of a long-term bond per SSAP No. 26. Most long-term certificates of deposit do not meet the qualifications of filing exempt with the SVO.

Concerns were brought forward to the **Task Force** in that the SVO filing fee would eliminate most of the anticipated earnings for these types of investments. Industry asked for the **Task Force** to consider whether the certificates of deposit should be exempt from filing with the SVO. The proposed amendment allows certificates of deposit issued by banks that are rated by an NAIC ARO to be filing exempt and to assign the NAIC designation equivalent to that of the issuer.

In response to this proposal industry has asked the Task Force to consider certificates of deposit that are below the FDIC limit in one financial institution regardless of whether it is rated or not to be considered exempt from filing with the SVO.

The **Task Force** received a report from NAIC staff in regards to filing exemption for transactions guaranteed by the FDIC. The staff was asked to review transactions guaranteed by the FDIC to assist in evaluating whether they should be exempt from filing with the SVO. The initial recommendation of the staff is that the subject transactions either be:

- Accorded filing exempt (FE) treatment under Part Two, Section 4(c)(iii) of the *P&P Manual* (the discretionary exemption); or
- Treated as structured securities required to be filed with the SVO.

This report was exposed for a 30 day comment period.

Financial Regulation—Investments, continued

The **Task Force** received a report prepared by the SVO staff on Contingent Capital Securities. Contingent capital securities are designed to provide an issuer with loss-absorbing capital when needed. Contingent capital is capital that converts automatically into the issuer's common stock when some contingent event occurs. The contingent event currently specified is a Tier-I capital ratio threshold, such as the 6% minimum ratio of Tier-I capital to risk-adjusted assets. Another new form of contingent securities has emerged, containing a write-down feature where the value of the bonds would be written down if the bank breaches a preset ratio.

Contingent capital securities have features that are consistent with traditional bonds such as:

- Count as "Lower Tier 2" capital securities prior to conversion;
- Count as Tier I capital securities upon conversion;
- May range from senior debt to a non-cumulative preferred security;
- Generally have a fixed-rate with specified coupon and final maturity dates;
- Coupon distributions and principal repayment are non-deferrable; and
- Non-payment is an event of default.

NAIC staff reported that their preliminary position is that contingent capital securities most resemble mandatory convertible (into equity) securities. The **Task Force** agreed to allow staff to continue monitoring this type of security and give suggestions on any reporting changes at a later date.

Also, the **Task Force** received a report on foreign securities held by a Subparagraph D Company. Subparagraph D refers to an insurer that gets more than 80 percent of its premium income from outside the U.S. Subparagraph D companies buy securities issued by local entities most of which are not rated by an NAIC ARO or assed by the SVO because of the costs associated with translating data into English. These companies self-designate the credit quality of the assets and affix an F to the NAIC designation.

AFLAC has 76.7% of its premium in Japan and has asked for a permitted practice from its state of domicile to utilize ratings from Japan rating agencies on securities that did not have ARO ratings. The following questions were brought before the **Task Force** in the report:

1. Is the limitation that only companies that derive no more than 20% of their gross worldwide premiums in the United States the best way to address the problem?
2. Should the 20% limitation for U.S. business be increased?
3. Should companies be permitted to use foreign rating agencies that are nationally recognized statistical rating organizations (NRSROs) — but not NAIC approved rating organizations (AROs) — in translating the rating into a designation, otherwise subject to the same rules as securities that qualify for FE treatment? Should those securities be notched by one NAIC designation? Should there be other limitations, such as not allowing loan-backed and structured securities for this treatment?
4. Are there additional foreign NRSROs that should be considered for ARO status, even for limited use, such as only for Issuer Obligations under All Other Governments category?
5. Is there another alternative that would better solve the problem?

The **Task Force** also formed a subgroup to address the role of the SVO in requiring insurance companies to file securities. Currently the *SVO Purposes and Procedures Manual* does not impose responsibility on the SVO staff to enforce compliance of reporting securities to the SVO. The subgroup is to consider whether it would be more efficient to give the SVO staff authority and resources to ensure securities are filed per the requirements. This would entail SVO staff determining if the security reported as filing exempt was actually rated, if the reported Z suffix securities are over the 120 day permitted filing period and whether insurers have filed securities that are not considered exempt.

Other Financial Regulatory Issues

The **NAIC/AICPA Working Group** decided not to pursue a blanks proposal that would require a reporting entity to disclose in a General Interrogatory its audit committee members and their independence. The Working Group instead encouraged insurance departments to verify compliance with audit committee requirements through discussions with insurers as deemed necessary.

In other matters, the Working Group discussed the following:

- I. SEC Rule on Compensation - At the Spring National Meeting, the Working Group discussed newly adopted SEC Rule 33-9089 on executive compensation and board of director structure. The Working Group reviewed a staff memo summarizing the new disclosures which require a narrative disclosure of the company's compensation policies as they relate to company risk management; the nature and extent of services of compensation consultants and detailed disclosures about the board of director leadership structure and why the chosen structure is best for the company.

Shortly after the National Meeting, the Working Group exposed for comment a blanks proposal with numerous additional disclosures to incorporate most of these SEC disclosures as a starting point for discussion. Interested Parties objected to the proposed detailed disclosures as they "do not appear to fit the intended purpose of the annual statement for solvency reporting." In addition, interested parties reiterated their concerns related to duplication of SEC disclosures in the statutory financial statements.

As an alternative proposal, Interested Parties proposed including revisions to the annual confidential Supplemental Compensation Exhibit and enhancements to the Examiners Handbook to provide an enhanced review of potential risks posed by insurer compensation plans. The Working Group agreed that interested parties should pursue this alternative.

At the Summer National Meeting, the Working Group discussed this counterproposal, which recommends the following revisions to the Supplemental Compensation Schedule:

- a. A new interrogatory that requires disclosure when an insurer has made material changes to the general philosophy and objectives of its material compensation policies and practices for employees;
- b. Reporting stock-based incentive compensation elements for key officers and certain other employees as well as directors;
- c. That publicly-held stock insurers (or insurers that are owned by public-held companies) have the option to file their annual proxy report with the domiciliary regulator in lieu of the Supplemental Compensation Exhibit.

The proposal also includes additional review steps in the Financial Examiners' Handbook, Exhibit M, Understanding the Corporate Governance Structure. The proposal expands guidance in the following areas: the general design philosophy of compensation programs and incentive plans, background and qualification of directors and nominees, board leadership structure and role, and the use of compensation consultants.

After reviewing the counterproposal, the Working Group concluded that the Interested Parties' proposal needs additional work including more disclosures on compensation plans and incentives, board leadership structure and the role of the board with respect to compensation. The Working Group then referred the initial Working Group proposal and the counterproposal to the Corporate Governance Working Group for its consideration.

2. MAR Implementation Issues - The Working Group exposed for comment proposed changes to the MAR Implementation Guide's sample management attestation reports to include additional sample wording for insurers where there were significant control processes not tested for SOX purposes due to group materiality considerations.

The Working Group then noted that the version of the Implementation Guide included in the 2010 *Accounting Practices and Procedures Manual* is not the most recently revised version. Interested parties should use the version posted to the NAIC Working Group's webpage instead.

Other Financial Regulatory Issues, continued

The **Examination Oversight (E) Task Force** updated the results of a survey to track states’ progress in adopting revisions to the “Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in Hazardous Financial Condition.”

The Model Act was revised last year to provide additional considerations to be made by the commissioner to determine whether the continued operation of any insurer might be deemed to be hazardous to its policyholders, creditors, or the general public. The revisions also give the commissioner increased authority to issue an order requiring companies deemed to be in a hazardous financial condition to take corrective action.

46 states responded that “they have reviewed the revisions to Model Act to compare the new standards and authority included in the model to current rules and regulations in their state” while five indicated such a review is in process and two other states indicated that such a review has not yet started. One state did not respond to the survey.

The survey also asked the following questions:

Does your state intend to adopt the revisions to Model 385, or adopt with changes?					
Adopted – 12	Adopt – 21	Adopt w/ Changes – 6	Don’t Plan to Adopt – 4	Not Sure Yet – 7	No Response - 1
Has your stated developed a timeline for the adoption of these revisions? If so, please indicate your proposed timeline in the space provided, along with details of where you currently are in the process.					
Adopted – 12	2010 – 9	2011 – 7	2012 – 2	No Timeline – 16	N/A or No Response – 5
Do you anticipate any problems in adopting the revisions to Model 385 in your state? If so, please provide detail on the anticipated problems in the space provided.					
No – 27	Yes – 0	Not Sure Yet – 7	N/A – 16	No Response – 1	

The **Financial Examiners Coordination Working Group** adopted a new Examination Coordination Framework for inclusion in the NAIC Financial Condition Examiners Handbook. The framework includes requirements related to the following:

- Coordination of holding company group exams;
- Review and reliance on another state’s workpapers; and
- Examinations of underwriting pools, syndicates and associations.

The **Financial Regulators Standards and Accreditations (F) Committee** took the following actions during the Summer National Meeting:

1. Voted to release the Risk-Based Capital for Health Organizations Model Act (#315) as a possible accreditation standard for a preliminary comment period of 30 days.
2. Adopted significant revisions made during 2009 to the *Financial Condition Examiners Handbook*, which consist of eighteen examination repositories for examiner use and the new information technology review process as a result of the newly effective risk focused surveillance approach to financial examinations.

The **Financial Condition (E) Committee** voted to form the Health Reform Solvency Impact (E) Subgroup. The Subgroup has been asked to “assess the solvency impacts/concerns for health insurers as a result of the recently passed Affordable Health Care for America Act (H.R. 3590) and recommend charges for the appropriate Financial Condition (E) Committee groups to address these impacts/concerns”. New York will chair the new subgroup.

Other Financial Regulatory Issues, Continued

The **Rating Agency Working Group** had its final report "Evaluating the Risks Associated with NAIC Reliance on NRSRO Credit Ratings" adopted by the Financial Condition Committee during an April 28 conference call after referring the remaining recommendations to other NAIC groups.

The final recommendations to the E Committee included the following:

1. Regulators should explore how reliance on ARO ratings can be reduced when evaluating new, structured, or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;
2. Consider alternatives for regulators' assessment of insurers' investment risk, including expanding the role of the NAIC Securities Valuation Office (SVO); and
3. When considering continuing the use of ratings in insurance regulation, the steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls, including the NRSROs' efforts in implementing the recommended structural reforms, should be taken into account.

The **Statutory Accounting and Financial Reporting Subgroup** formed at the 2010 NAIC Spring National Meeting released a "preliminary considerations" document that included the following issues for comment:

- What should be the purpose of the regulatory accounting model?
- Given that the IAIS and major jurisdictions are advocating the use of IFRS (possibly with modifications) for regulatory purposes, should the NAIC continue to maintain an entire codification of statutory accounting?
- Should regulatory financial statements be utilized for public purposes or should a separate public financial filing be required?

In addition, NAIC staff prepared a detailed analysis of five different accounting basis possibilities that the subgroup could consider:

1. Freeze SAP without any IFRS/GAAP conversion item changes;
2. U.S. GAAP with statutory adjustments, with a step by step review of IFRS/GAAP convergence items;
3. IFRS with statutory adjustments;
4. IFRS for public companies and IFRS/GAAP with statutory adjustments for nonpublic companies; and
5. IFRS without any statutory adjustments on these issues.

Several regulators commented that they believe no change to the current process is required as the recent financial crisis demonstrated that statutory accounting is an effective regulator basis of accounting. They believe that the SAP Working Group should continue its current process to review new GAAP guidance as it is issued, which would include all IFRS convergence guidance.

The Subgroup directed NAIC staff to incorporate revisions to the documents and re-exposed them for comment. The Subgroup's anticipated deadline for a final decision on whether to pursue another basis of accounting for regulatory purposes is December of 2011 which could be affected by the timing of any SEC decision.

The **Group Solvency Issues Working Group** adopted the following changes to Insurance Holding Company System Model Act (#440) and Insurance Holding Company System Model Regulation (#450) for consideration by the Financial Condition (E) Committee:

- a. The concept/definition of "contagion risk" of entities within a holding company group added in earlier draft revisions was replaced with "enterprise risk identification," which is defined as "any activity, circumstance, event or series of events involving one or more affiliates of an insurer, that, if not remediated promptly, is likely to have a material adverse effect upon the financial condition or liquidity on the insurer or the insurance holding company

Other Financial Regulatory Issues, continued

system as a whole." Model Regulation on affiliate agreements to enhance significantly the minimum requirements for cost sharing and management agreements.

- b. A new section 7 was added to the Model Act to give the commissioner the authority to establish and/or participate in supervisory colleges for insurers with international operations.
- c. There was significant discussion as to whether the Form B filings should require a statement that the board of directors "is responsible" for corporate governance and internal controls or just oversees such processes. As a compromise, the Working Group included both alternatives for states to choose from, i.e. "the board is responsible for and oversees" or "the board oversees."
- d. Enhancements were made to allow examination of affiliates including access to books and records to "better ascertain the financial condition of the insurer and any contagion risk within the insurance group."
- e. Added a requirement to file Form Bs (annual registration statement) and Form Cs (changes to the registration statement) with the NAIC. The regulators believe centralized data collection and sharing is crucial to an effective national state-based system of insurance regulation.

Interested Parties expressed concern about confidentiality issues of filings with the NAIC. It was noted that at least one state does not allow information to be kept confidential when it is also filed with the NAIC. NAIC legal counsel noted that the proposed changes to the Model Act include specific provisions that allow such information to be kept confidential when adopted by a state, similar to the RBC Model Act.

- f. Added a requirement for prior notice of divestiture of controlling interests in an insurer.

The E Committee adopted the proposed changes and will be discussed by the NAIC Executive Committee at the 2010 NAIC Fall National Meeting. The NAIC anticipates that the revised models will be ready for legislative consideration in January 2011.

The **Investments of Insurers Model Act Revision Working Group** held a conference call July 20 to hear a presentation from the ACLI on how life insurers use derivatives to manage asset and liability risk.

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Upcoming NAIC Meeting Schedule

2010 Fall National Meeting	October 18—21, 2010	Orlando, FL
2011 Spring National Meeting	March 26—29, 2011	Austin, TX
2011 Summer National Meeting	August 30—September 2, 2011	Philadelphia, PA
2011 Fall National Meeting	November 3—6, 2011	Washington, DC

2010 Millennium Consulting Seminars

Investment Accounting and Reporting Workshop	June 21—22	Miami, FL
Introduction to Health Statutory Accounting and Reporting Seminar	July 28—30	San Francisco, CA
2010 Health Annual Statement Preparation Seminar	August 23—26	Chicago, IL
Claims Accounting and Reporting Workshop	September 9—10	Dallas, TX
Regulatory Update for Health Organizations Workshop	September 27	Detroit, MI
Regulatory Update for Health Organizations Workshop	September 28	Dallas, TX
Regulatory Update for Health Organizations Workshop	September 29	Orlando, FL
Introduction to Health Statutory Accounting and Reporting Seminar	November 17—19	Orlando, FL
2010 Health Annual Statement Preparation Seminar	Nov 29—Dec 2	New Orleans, LA
2010 Risk-Based Capital Preparation Seminar	December 3	New Orleans, LA

Questions or additional information regarding items discussed in this publication should be directed to:

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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.

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