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## NAIC Hot Topics

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# NAIC REGULATORY UPDATE

This quarterly issue of the *NAIC Regulatory Update* summarizes the National Association of Insurance Commissioners' financial activities affecting health entities at the 2006 Winter National Meeting. The meeting took place December 9-12, 2006 in San Antonio, Texas.

## Financial Regulation—Risk-Based Capital

The **Capital Adequacy Task Force** adopted a change to each 2007 RBC formula by adding rows for each asset class of hybrid securities reported as preferred stock. Currently the factors are the same as preferred stock but likely be modified after the American Academy of Actuaries (AAA) finishes its analysis of the risks associated with these securities. Hybrid securities are investments structured with characteristics of both equity (common and preferred stock) and debt.

The issues emanates from the fact that there are only two categories of RBC risk factors that can be assigned to hybrid securities. Either the security receives the more favorable factor assigned to bonds and preferred stock (ranging from 0.3% to 30% depending on NAIC Designation) or it receives the 30% factor assigned to common stock in the Life formula or the 15% factor in the Health and P&C formulas. Consequently the Working Group had to determine the differences between hybrids and preferred stock and the risks that are or are not captured by an NRSRO credit rating.

The Task Force also adopted a recommendation from the Health Risk-Based Capital Working Group to forego its review of expense factors related to cost containment. The Working Group had proposed to review the risk factors in the Health RBC formula for cost containment expenses with regard to the recent changes in the Health blank to separately identify cost containment from other administrative expenses. The Health RBC Working Group determined that the risk factors for administrative, cost containment and claims adjustment expenses do not require a change. Therefore, the variable factor of 4% – 7% based on premium volume will stay the same for these expenses.

The **Health Risk-Based Capital Working Group** decided to move forward in the development of a trend test for Health RBC formula similar to the Property/Casualty trend test. The Working Group and the AAA believe that the Health formula has enough experience to move forward on developing the trend test. However some members of the Working Group are not convinced that the Health RBC needs a trend test or if it will reflect an accurate assessment to the health underwriting cycle.

A proposal will be exposed for comment during a conference call in April 2007. With the delay in exposure, the earliest the Working Group could incorporate this change into the Health RBC formula would be for year-end 2008 reporting. In addition, this would require that the Health RBC Model Law be modified in order to allow states to take action based on the results of the trend test.

Currently the P&C RBC formula's Trend Test triggers a Company Action Level when an RBC percentage is between 200% and 300% (Total Adjusted Capital divided by Authorized Control level RBC) and there is a combined ratio of greater than 120%. The combined ratio is calculated as follows:

$$\text{Combined Ratio} = \text{Loss Ratio} + \text{Dividend Ratio} + \text{Expense Ratio}$$

### Financial Regulation—Risk Based Capital, *Continued*

The Health RBC Working Group also has charged the AAA with proposing a set of RBC factors for excess of loss products. The AAA is evaluating the current Stop Loss RBC charges based on more data and experience for these products than was available when the current RBC factor was developed. In line with this work, the Working Group is determining if high deductible and healthcare savings account policies should be reported as part of stop loss or as comprehensive medical lines of business.

The **Hybrid Risk-Based Capital Working Group** continued its discussion on a long-term solution regarding appropriate risk charges for hybrid securities in the three RBC formulas. At the 2006 NAIC Fall National Meeting a short-term solution was adopted (see NAIC Update September 2006). At the Winter Meeting, in coordination with the Invested Assets Working Group, a work plan developed by the AAA was adopted. The work plan calls for the AAA to “identify hybrid securities, including preferred and surplus notes and recommend changes from existing RBC treatment. The AAA has been asked to complete this charge by the NAIC 2007 Fall National Meeting. Changes to both the 2007 annual statements and RBC formulas are expected.

### Financial Reporting

The **Blanks Working Group** adopted 11 proposals previously exposed for comment, including relocating the investment summary schedule to the “E” pages and adopted guidance documents to be posted to the Blanks Working Group Web Site for hybrid securities and finite reinsurance for year-end 2006. Sixteen new proposals were exposed for comment, including proposals regarding securities lending and hybrid securities, which were simultaneously referred to the Capital Adequacy Task Force and Hybrid RBC Working Group, respectively.

The Working Group adopted three disclosures for the year end 2006 Notes to Financial Statements. The following disclosures are in amended 2006 NAIC Annual Statement Instructions on the NAIC website:

21F — Hybrid Securities - At the 2006 Fall National Meeting, the Hybrid RBC (E) Working Group adopted a proposed disclosure for hybrid securities.

21G — State Transferable Tax Credits - On June 12, 2006, the Statutory Accounting Principles (E) Working Group adopted SSAP No. 94 – Accounting for Transferable State Tax Credits which included a nonsubstantive change in the disclosure requirements effective year-end 2006 reporting.

21H — Impact of Medicare Modernization Act on Postretirement Benefits - On Dec. 4, 2004, the Emerging Accounting Issues (E) Working Group adopted disclosure requirements under INT 04-17: Impact of the Medicare Modernization Act on the Postretirement Benefits.

The Working Group adopted other items affecting the Health and other statements including:

Item	Effective Date
Required an Index on the Inside Cover of the Statement	Annual 2007
Relocated Investment Summary Schedules with Detail Investment Schedules	1 <sup>st</sup> Quarter 2008
Added New Line to Five-Year Historical Data for Net Cash from Operations	Annual 2007
Removed “with the State of Domicile” from Heading of Columns 3 and 4 on Schedule E, Part 3 Special Deposits	Annual 2007
Added Column on Exhibit of Capital Gains to Separate Foreign Exchange-Related Unrealized Gains	Annual 2007
Added Interrogatory to Allow Regulators to Easily Identify Companies Preparing Statements using Generally Accepted Accounting Principles	Annual 2007

## Financial Regulation—Accounting

The **Statutory Accounting Principles Working Group** held a public hearing to in which they addressed eight issues addressing either changes to the 2007 NAIC *Accounting Practices and Procedures Manual* or documents being exposed for comment.

### 1. **SSAP No. 96 – Settlement Requirements for Intercompany Transactions, an Amendment to SSAP No. 25**

The Working Group adopted SSAP No. 96 but amended to have an effective date of December 31, 2007 instead of January 1, 2007. In addition, the Working Group clarified that the SSAP No. 96 is not all-inclusive for intercompany transactions, for example, it would not apply to reinsurance transactions between related parties.

SSAP No. 96 requires that transactions between related parties to be in writing and that the written agreement provide for timely settlement for amounts owed, with a specific due date. Amounts more than 90-days past due from the due date will be nonadmitted.

### 2. **Ref No. 2005-17 – Move INT 03-17 Disclosure to SSAP No. 55**

The Working Group adopted Ref No. 2005-17 which moves the disclosure requirement regarding “classification of certain liabilities from extra contractual obligation lawsuits” currently found in INT 03-17 to SSAP No. 55 effective December 31, 2007. The amendment also proposes putting a disclosure in the annual statement to disclose the “amounts of any claim/loss related to extra contractual obligation lawsuits or bad faith lawsuits.”

### 3. **Ref No. 2006-10 – Clarify the Amortization Period in SSAP No. 62, Para 51**

The Working Group adopted Ref No. 2006-10 which amends paragraph 51 of SSAP No. 62 – *Property and Casualty Reinsurance* to clarify that the pro-rata amortization period for the liability (difference between the anticipated acquisition cost and the reinsurance commission) be amortized over the effective period of the reinsurance agreement in proportion to the amount of reinsurance coverage under the contract.

### 4. **Ref No. 2006-11 – Multi-cedent Reinsurance Agreements**

The Working Group re-exposed for comment Ref No. 2006-11 after it was amended to include a separate section of SSAP No. 62 to address reinsurance agreements with multiple cedents and to require such agreements to be “in writing,” and to have “fair and equitable” terms of allocation.

### 5. **Ref No. 2006-13 – FAS 123(R): Share-Based Payment**

The Working Group NAIC deferred action on Issue Paper No. 129 - *Share-Based Payment, A Replacement for SSAP No. 13 - Stock Options and Stock Purchase Plans* which was exposed for comment in September 2006. The Issue Paper is based on a review of FAS 123(R) and FSP FAS123(R)-1. Industry commented that the Issue Paper does not clearly address the accounting in situations where a holding company parent is the issuer of share-based payments and costs of the plan are allocated to the members in the holding company system. The Working Group plans to hold a conference call in 2007 to address the outstanding issues.

### 6. **Ref No. 2006-17 – Appendix to SSAP No. 88 – Investments in SCA Entities (Q&A Implementation Guide)**

The Working Group discussed the SSAP 88 Implementation Guide which was exposed in June 2006 to address 15 issues that have been raised since the implementation of SSAP No. 88. The Working Group held two interim conference calls subsequent to the 2006 NAIC Fall Meeting to discuss proposed changes to the Q&A but was unable to reach closure on a number of issues, including:

- Paragraphs 8 and 9 which would allow audits of combined financial statements and not just consolidated financial statements;
- The requirement that a GAAP audit must be performed of a downstream holding company even all the entities owned by the downstream holding company obtain separate stand alone GAAP or SAP audits.

**Financial Regulation—Accounting, Continued**

Consequently due to these and other issues addressed during the interim conference calls and the need to have guidance in place for the 2006 filing date, the Working Group issued a proposed “Transitional Guidance” on November 30<sup>th</sup>. The Transitional Guidance was addressed this meeting and re-exposed for comment until December 20, 2006. The Transitional Guidance addresses three key issues with the remainder of the issues from the Q&A Implementation Guide being deferred for further consideration until 2007. The three key issues are:

- Is an audited balance sheet acceptable to meet the SCA requirement of SSAP No. 88?
- The tentative conclusion on this issue is that “an audited balance sheet would be deemed sufficient to meet the SCA requirements for subsidiaries under para 8.b.ii, 8.b.iii and 8.b.iv, for year-end 2005 and 2006 reporting only.
- If a downstream SCA holding company is merely holding SCA entities and does not own any other additional assets and is not held liable for any other liabilities or obligations, is an audit of the financial statements of the holding company required, or is a “look-through” approach permitted?
- The tentative conclusion on this issue is that it is acceptable to apply a “look-through” approach in this situation.
- Would an audit of the consolidated financial statements of a non-insurance holding company parent with consolidating balance sheets of the insurance companies and its subsidiaries meet the requirements for audited financial statements of the subsidiaries under para 18?

The tentative conclusion on this issue is that the “GAAP audit of the non-insurance holding company parent does not meet the requirements per para 18.

**7. Ref No. 2006-25 – Modifications to Paragraphs 8-9 and 17-18 of SSAP No. 88 Q&A Implementation Guide**

The Working Group deferred action and re-exposed this item for comment. This issue was exposed for comment during the interim conference calls related to Ref No. 2006-17. The proposal changes paragraphs 8 and 9 to allow combined or consolidated audits. It also attempts to clarify the downstream holding company valuation and audits. If these changes are adopted, conforming changes to the Q&A would be needed in regards to Ref No. 2006-17.

**8. Ref No. 2006-23 – Clarify Scope of SSAP No. 62, Paragraph 72-78 Disclosures**

The Working Group adopted a nonsubstantive change to para 72 of SSAP No. 62 – *Property and Casualty Reinsurance* to note that the audited disclosures for finite reinsurance are limited to contracts renewed on or after January 1, 1994.

During the regular meeting the Working Group exposed for comment a number of items. In particular impact to health entities the following items were exposed for comment as nonsubstantive changes:

**I. Ref No. 2006-31 – Disclosure amendment to SSAP No. 10 for Protective Tax Deposits.**

The Working Group exposed for comment a nonsubstantive amendment to SSAP No. 10 to disclose the “the aggregate amount of deposits admitted under Section 6603 of the Internal Revenue Service (IRS) Code.”

Section 6603 provides the following with regard to these special protective tax deposits:

- It is a deposit not a tax payment.
- The deposit prevents the IRS from charging the taxpayer underpayment interest on amounts determined to be owed up to the amount of the deposit (thus providing a savings to the insurer and its policyholders).
- The deposit will be refunded to the taxpayer upon request in writing.
- The IRS will pay interest on the deposit if it is refunded to the taxpayer.

## Financial Regulation—Accounting, *Continued*

### 2. Ref No. 2006-18 Accounting for Uncertainty in Income Taxes.

The Working Group is drafting an Issue Paper to address the accounting for uncertainty in tax positions and the inconsistencies that could exist among annual statement filings based on FIN 48: *Accounting for Uncertainty in Income Taxes*. The Issue Paper will be provided to the FIN 48 subgroup in the first quarter of 2007. The expectation is that the Issue Paper will mirror GAAP guidance to minimize the many complexities related to this issue.

### 3. Ref No. 2006-24 – SSAP No. 61 Ceding Commissions

The Working Group exposed a nonsubstantive change to SSAP No. 61 to clarify that entities reporting on the Health Annual Statement must report commissions and expense allowances on reinsurance ceded as an “offset to administrative expenses.”

### 4. Ref No. 2006-30 FAS 158: Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)

The Working Group moved this issue to the Substantive Active List and formed a sub-group to address a number of issues including the reconsideration of whether statutory accounting should follow GAAP accounting guidance for FAS 158 and eliminate the statutory accounting guidance that excludes “nonvested employees” when accounting for pensions and other postretirement benefits. Industry has commented that the expense of having two separate calculations for GAAP and SAP is not cost effective.

The **Emerging Accounting Issues Working Group** adopted as final several Interpretations that were previously exposed for comment. These Interpretations are effective for year-end 2006 and include:

#### 1. INT 06-07: Definition of Phrase “Other Than Temporary

The Working Group reached a final consensus position incorporating portions of FAS 115-1 and 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (the FSP) paragraphs 6, 7, and 11. The Working Group rejected other concepts found in paragraphs 1-5, 9-10, 12-15, and 19. The Interpretation provides detailed analysis of how it differs from the FSP, EITF 03-01, FSP 03-1-1 and INT 02-07.

The Interpretation adopts a three step impairment process included in the FSP and also provides guidance on interest related impairments. Interest related declines in value, which includes changes in general credit spreads, are only recognized when the insurer has the intent to sell the security.

#### 2. INT 06-12: Tax Deposits Submitted in Accordance with Section 6603 of the IRS Code

The Working Group reached a final consensus position on the reporting and admissibility requirements for tax deposits made pursuant to the IRS Code, Section 6603. The Interpretation clarifies that:

- Any Section 6603 tax deposit tax asset should offset any tax liability;
- Any tax deposit asset that will not be recovered in a subsequent accounting period should be nonadmitted;
- The reporting entity should report any tax asset deposit gross of any related tax liability under the “Current Federal and Foreign Income Tax Recoverable and Interest Thereon” line of the balance sheet.

#### 3. INT 06-13: EITF 01-2: Interpretations of APB Opinion No. 29

The Working Group reached a final consensus position on the accounting for nonmonetary transactions.

## Financial Regulation—Investments

The **Valuation of Securities Task Force** adopted the “Report on Transparency of the NAIC Securities Valuation Office” which contains recommendations on the issue of transparency of SVO operations. The Task Force adopted a proposal made by the New York Department that contained five specific recommendations on this issue:

1. Post SVO Determinations on publicly traded securities on the NAIC Website. The SVO is still working with its IT department to figure out a way to post the classification of hybrid information automatically on the website. This posting will have publicly traded securities with rating and classifications.

**Financial Regulation—Investments, *Continued***

2. Permit broker-dealers to directly request SVO analysis of new and evolving securities. At the 2006 NAIC Winter National Meeting the Task Force adopted a proposal to allow broker-dealers and issuers access to the advance rating and emerging vehicle services of the SVO.
3. Publish research reports explaining the SVO methodology for classifying securities. The SVO is in the process of writing research papers on how their methodology is used.
4. Amend the Purposes and Procedures Manual to clarify issues that contributed to the confusion over hybrid securities.
5. Reestablish the Invested Asset Working Group as a central forum to study technical issues related to new investment vehicles.

The Task Force adopted two amendments to the SVO *Purposes and Procedures Manual*:

1. Part Fourteen to clarify that capital and surplus debentures not rated by a NRSRO and those rated by a NRSRO at the equivalent of a NAIC 2-6 Designation are:
  - Not eligible for filing exemption for NRSRO rated instruments;
  - Are reported on Schedule BA and not on Schedule D; and
  - Should be filed with the SVO so that the SVO can determine the statement factor used to calculate the carrying value per SSAP No. 41.
2. In addition to the change to Part Fourteen, Part Twelve was revised to clarify that there are two separate processes that apply to surplus and capital debentures.

The Task Force approved the reconstitution of the Invested Asset Working Group. The Working Group existed prior to 2002 and focused on some of the more technical issues on new investments and on guidance for regulation for those investments. The newly reconstituted Working Group will be charged with the same mission. In addition, the Working Group was asked to study a new investment called "Constant Proportion Debt Obligations" (CDPOs) and to make a recommendation as to how CDPOs should be treated for statutory accounting and reporting purposes.

In other actions the Task Force:

1. Received a report from the Derivatives (E) Working Group which was established to study the derivatives marketplace in order to consider whether the NAIC Derivative Instruments Model Regulation (#282) should be discarded or updated. The Working Group has held two meetings since April 2006 during which they heard presentations from industry representatives on current issues in derivatives. Issues that are being addressed include:
  - Whether insurance companies should get a credit for hedging derivative transactions that would function in the same way as credit for reinsurance.
  - Whether transparency of the information on Schedule DB could be improved.
  - The increased use of derivatives by financial guarantee insurers. The issue here is whether there is a need for more disclosure and, if so, how to achieve that disclosure, given that many of those transactions are done through affiliated companies.

The Working Group expects to hold conference calls in January 2007 to continue work on this charge.

2. Received a report from SVO staff indicating the 2007 NAIC budget increases SVO fees. These will be incorporated in the appendix to the *Purposes and Procedures Manual*. Securities filed in 2006 would be charged the current, not the new, fee.

## Other Financial Regulatory Issues

The **NAIC/AICPA Working Group** discussed that the Implementation Guide created to assist insurance companies in complying with the new requirements contained in the revised Annual Financial Reporting Model Regulation (Model Audit Rule). The Implementation Guide will become an appendix in the *2007 Accounting Practices and Procedures Manual*.

In other actions the Working Group:

1. Heard a report from the American Institute of Certified Public Accountants (AICPA) regarding SAS No. 114, *The Auditor's Communication with Those Charged with Governance*, which replaces SAS No. 61. SAS No. 114 establishes standards and provides guidance to the auditor on matters to be communicated with those charged with governance. The SAS is effective for audits of financial statements for periods beginning on or after December 15, 2006.
2. Discussed Section 11 - Communication of Internal Control Related Matters Noted in an Audit guidance and its applicability until the Model Audit Rule revisions are effective. Under Section 11 the insurer is expected to maintain information about significant deficiencies communicated by the independent CPA and make such information available for review to the examiner conducting a financial condition examination.
3. Discussed the process for maintaining and updating the Model Audit Rule and the process to periodically review the premium threshold amounts. It is expected the Working Group will propose a procedure for updating the Model Audit Rule similar to what is in place for updating the *Accounting Practices and Procedures Manual*.
4. Discussed a letter from the National Council of Insurance Legislatures (NCOIL) president that was sent to state legislative leadership and state committee chairs related to revisions to the Model Audit Rule. Although several trade associations sent a letter in response to the NCOIL letter indicating "the model reflects careful and thoughtful deliberations, limited scope and enhances regulatory oversight without undue burden to the industry" NCOIL continues to oppose in principle the application of these requirements to nonpublic companies. Adoption of the revised Model Audit Rule will be a state-by-state consideration.

The **Risk Assessment Working Group** adopted as final the Risk-Focused Guidance (413 pages) for inclusion in the NAIC *Financial Condition Examiners Handbook (Handbook)*. The Working Group also adopted revisions to the Accreditation Review Team Guidelines. The Guidance will become effective as an accreditation standard for examinations that commence after January 1, 2010.

The **Financial Examiners Handbook Technical Group** received a status update on the revisions to the NAIC *Financial Condition Examiners Handbook* been drafted by the Risk Assessment Working Group. The Technical Group also adopted the following items:

1. Revisions to the *Handbook* in response to a referral from the Financial Examination Modernization Working Group (FEMWG) relating to review and reliance on another state's workpapers.
2. A standardized data request template for insurer information requests. The template provide insurers under examination a mechanism for identifying what baseline electronic information (electronic premiums, claim detail tapes, etc.) is to be provided on examination and the format the information is to provided in. A separate template was developed for Life, P&C and Health companies. The data request templates address only premiums, claims and reserves data.
3. Adopted revisions to the *Handbook* in response to the FEMWG's referral relating to definitions of full- and limited-scope examinations.

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## 2007 NAIC Election of Officers

The NAIC Executive (EX) Committee/Plenary Committee held its annual election of officers. The following individuals were elected for 2007:

Commissioner Walter Bell, Alabama – President

Commissioner Sandy Praeger, Kansas - President Elect

Commissioner Roger A. Sevigny, New Hampshire - Vice President

Commissioner Jane L. Cline, West Virginia - Secretary-Treasurer

## 2007 NAIC Meeting Schedule

Spring National Meeting:	March 10–12, New York, NY
Summer National Meeting:	June 2–5, San Francisco, CA
Fall National Meeting	September 29–Oct 2, Washington, DC
Winter National Meeting:	December 1–4, Houston, TX

Questions or additional information regarding items discussed in this publication should be directed to Bruce A. Cromartie at 919.522.9678 or by email at [bcromartie@nc.rr.com](mailto:bcromartie@nc.rr.com) or Colleen Gingrich at 913.961.0619 or by email at [cging@everestkc.net](mailto:cging@everestkc.net).

### **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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