

June 30, 2009

## Suitability, Solvency Modernization, International Accounting and Derivatives: The NAIC 2009 Summer Meetings

U.S. insurance regulators from the 50 states met in Minneapolis over June 11-16, 2009 at the National Association of Insurance Commissioners (NAIC) Summer Meetings to address a host of issues ranging from the suitability of annuity sales to solvency modernization. The Meetings occurred against the backdrop of the Obama Administration poised to issue its plan for financial regulatory reform within the week, and international insurance regulators expected to issue new rules on solvency margins for international insurers within the next month. This Legal Alert discusses some of major developments that emerged from the Meetings.

### Life Insurance

**Suitability.** The **Suitability of Annuity Sales Working Group** of the Life Insurance and Annuity (A) Committee met for six hours over the course of two days at the Summer Meetings. The Working Group focused on the proposed revisions to the **Suitability in Annuity Transactions Model Regulation** (Model 275). The Working Group began by receiving a presentation from member representatives of the American Council of Life Insurers (ACLI) explaining and identifying the myriad channels through which annuities are distributed. Much of the meetings focused on receiving specific comments on numerous aspects of the current "Discussion Draft" of the Model Regulation. As a general matter, trade associations and other representatives of life insurers attempted to persuade the Working Group to consider shifting to an approach of addressing the proposed clarification or modifications to suitability requirements through an alternative method such as:

- interpretive guidance or bulletins; or
- adopting the concepts in the Market Conduct Examiners Handbook.

Ultimately, over the objections of two states, the Working Group voted to create an updated draft reflecting changes to the Model Regulation agreed to during the course of six hours of meetings, and approved such draft as an Exposure Draft. It was anticipated at the time of the meeting that the Exposure Draft would be circulated several weeks after the conclusion of the meetings. As of the date of this Legal Alert, the Exposure Draft for Model 275 has not yet been circulated.

**Guaranty Fund Disclosure.** The **Annuity Disclosure Working Group** of the Life Insurance and Annuities (A) Committee met to continue its discussions of potential changes to the disclosure template required by Section 19 of the **Life and Health Insurance Guaranty Association Model Act** (Model 520). The Working Group, and those providing comments, expressed different viewpoints with respect to the appropriate timing for delivery of any required disclosure to policyholders providing information on guaranty fund coverage. The Working Group decided to continue to collect comments on the disclosure template and hold a conference call in July to discuss the comments. The next step after the conference call would likely be to expose a new draft of the template to the Receivership and Insolvency Task Force of the Financial Condition (E) Committee for further action.

**Illustrations.** The **Annuity Disclosure Working Group** also met to discuss proposed changes to annuity illustrations. Much of the meeting itself focused on review and comment by the American

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Academy of Actuaries on the current ACLI template for such illustrations. The timetable appears to be to hold several conference calls on the matter in August, with the goal of completing work by the Winter Meetings.

## Solvency Modernization Initiative: Principles-Based Reserving

After years of consultation with the industry and the actuarial profession, the NAIC adopted “Principles for the NAIC’s Adoption of a Principles-Based Reserving Approach” in June 2008 in order to guide the NAIC through the complex process of developing and adopting a principles-based approach to reserving for U.S. life insurance companies.<sup>1</sup> The project has been divided into two stages. Stage 1 consists of all the deliverables that must be completed before the adoption of principles-based reserving by the NAIC, and includes adoption by 75% of the state legislatures of the necessary changes to the NAIC’s Model Standard Valuation Law and to the Valuation Manual. Stage 2 consists of all deliverables that can be completed after the adoption of the Standard Valuation Law.

Current estimates are that adoption by 75% of the state legislatures would occur no earlier than 2012 and that principles-based reserving would be introduced initially for term life, and possibly for universal life products with secondary guarantees, with work continuing on guidelines for variable annuities.

**Standard Valuation Law.** In a major milestone toward modernizing reserve requirements for U.S. life insurance companies, the **Life Insurance and Annuities (A) Committee** voted to expose for 30 days revisions to the **Standard Valuation Law** (Model 820) that had been approved by the Life and Health Actuarial Task Force (LHATF) to enable a principle-based approach to reserve valuation. Click [here](#) for a copy of the Exposure Draft approved by the (A) Committee. On July 28, 2009, the Life Insurance (A) Committee and the Solvency Modernization Initiative (EX) Task Force will hold a joint conference call to consider possible adoption of the Exposure Draft of the Standard Valuation Law.

Section 12 of the proposed Standard Valuation Law contains important corporate governance provisions that have been, and will continue to be, the subject of much comment.

**Sutherland Comment:** Companies should pay particular attention to the proposed corporate governance language in Section 12 of the Standard Valuation Law and consider whether comments should be submitted to the Life Insurance (A) Committee before the July 28<sup>th</sup> call.

As currently drafted, Section 12 would require a company using principles-based valuation to establish “procedures for corporate governance and oversight of the actuarial valuation function consistent with those described in the valuation manual.”<sup>2</sup> In addition, the company must “provide to the commissioner and to the board of directors an annual certification of the effectiveness of internal controls with respect to principles-based valuation. Such controls shall be designed to assure that all material risks inherent in the liability and associated assets subject to such valuation are included in the valuation, and that valuations are made in accordance with the valuation manual.”

<sup>1</sup> A principles-based approach to statutory Risk-Based Capital (RBC) and minimum reserve requirements is a new framework for determining life insurers’ required capital and reserves in the United States. The new method is based on a set of core principles and uses risk analysis and risk management techniques, including stochastic models, to capture underlying life insurance and annuity risks, benefits and guarantees in a manner that proponents claim is more accurate than the current rule-based, one-size-fits-all approach.

<sup>2</sup> The proposed corporate governance procedures to be contained in the valuation manual are discussed below.

**The Valuation Manual.** In another milestone, a **revised corporate governance framework** for principles-based reserving, Section VM-G for the Valuation Manual, was exposed for two weeks. Click [here](#) for a copy of Section VM-G that was exposed for comment. This document sets forth new responsibilities for the board, senior management and the Appointed Actuary with regard to the adequacy of principles-based reserves. For the first time, the board of directors will be explicitly responsible for oversight of the actuarial function in relation to principles-based reserving, as well as the policies that relate to the adequacy of principles-based reserves.<sup>3</sup>

Senior management would be responsible for ensuring that an appropriate infrastructure (consisting of policies, procedures, controls and resources) is in place for implementing and overseeing the principles-based reserve process, for reviewing principles-based reserving, and for adopting internal controls. Senior management is also responsible for model-based valuations, including establishing a process to validate the model.

The insurer's Appointed Actuary would be responsible for reviewing and approving the internal standards for actuarial processes, controls and documentation relating to principles-based reserving, including internal modeling, and for producing a report on the actuarial processes and results for the board of directors and senior management. The Appointed Actuary would also be required to provide a certification on the adequacy of principles-based reserves as part of his/her annual Statement of Actuarial Opinion.

**Other Elements: Statistical Agent.** Regulators have recognized that a statistical agent must be developed to collect data for a standard reserve-setting benchmark. New York regulators are working on a plan to put a statistical agent and process in place, with significant progress expected to be made on this project prior to the Fall NAIC Meetings.

**Nonforfeiture Law.** The American Academy of Actuaries is working on developing new nonforfeiture guidelines that will line up nonforfeiture requirements with principles-based reserving, and respond to numerous deficiencies in the current formula-based nonforfeiture mandates that have become nonresponsive to products emerging in the life insurance and annuity marketplace.

## Solvency Modernization Initiative: Group Supervision and International Accounting

The NAIC announced its Solvency Modernization Initiative (SMI) in June 2008 to "examine international developments and their potential use in U.S. insurance regulation". The **Solvency Modernization Initiative (EX) Task Force** (SMITF) is focused on preparing an analysis of the U.S. solvency system for insurance companies compared to the international solvency ideas embodied in the European Union's Solvency II system, the Basil II international capital framework for banks, the solvency work of the International Association of Insurance Supervisors (IAIS),<sup>4</sup> the solvency proposals in place or under development in Australia and Canada, and the international accounting standards being developed by the

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<sup>3</sup> The board of directors would also be required to: (i) review of the infrastructure (consisting of risk tolerance, policies, procedures, controls, risk management strategies, and resources) that senior management has put in place to implement the principles-based reserving function; (ii) review of principles-based reserve elements (consisting of the assumptions, methods, and models used to determine principles-based reserves for the company) that senior management has put in place; and (iii) document the board's review of the principles-based reserving function in the board minutes.

<sup>4</sup> The IAIS is an international body whose membership includes insurance regulators and supervisors from over 190 jurisdictions, including the United States.

International Accounting Standards Board (IASB). Once the analysis is complete, the SMITF will establish a roadmap for incorporating these new solvency ideas into the U.S. insurance regulatory framework.

The **Solvency Modernization Initiatives (EX) Task Force** heard a presentation from Dr. Therese (Terri) Vaughan, CEO of the NAIC, on her paper “The Implications of Solvency II for U.S. Insurance Regulation.” Dr. Vaughan focused on the three pillars of Solvency II: Quantitative Requirements (capital and reserves), Supervisory Review (Enterprise Risk Management and Internal Modeling), and Supervisory Reporting and Public Disclosure, and compared them to the U.S. solvency system with its standard RBC formulae, its incremental, targeted use of internal models for RBC C-3 Phase I (interest rate risk for fixed annuities), RBC C-3 Phase II (variable annuities) and its four levels of regulatory action. Dr. Vaughn discussed the pros and cons of each system within the context of lessons learned from the current economic crisis (in particular, whether companies have sufficient incentives to manage their own risks), and took a skeptical approach to over-reliance on internal models without the checks and balances of regulatory rules requiring a minimum floor on capital and reserves standards. Dr. Vaughn also noted that the IAIS standard of requiring a company to assess the quality and adequacy of its capital resources under its “Own Risk and Solvency Assessment” (ORSA) was an interesting idea that the NAIC would be looking at more closely.

The SMITF also heard a presentation on “Issues for Consideration in the Solvency Modernization Initiative” by Ramon Calderon, Deputy Commission, California Department of Insurance. Among the ideas that the SMI Task Force is considering:

- **Enterprise Risk Management:** A company’s “Own Risk and Solvency Assessment” (ORSA) could be useful and could build on the supplement to the annual statement titled “Management Discussion and Analysis” that insurers are currently required to file under the revised Model Audit Rule;
- **Corporate Governance:** While the NAIC has initiated certain corporate governance changes through the Model Audit Rule and others being considered in the principles-based reserving initiative, these corporate governance initiatives have been targeted to specific products and business functions. The SMI should consider whether a broader governance framework should be implemented for all products and functions, and how it could be implemented and enforced;
- **More Use of Internal Models:** Should the NAIC encourage the use of internal models, with appropriate safeguards, to more accurately assess the capital needs of a company? Should more modeling be involved in Risk-Based Capital (RBC) calculations, as the NAIC moves to principles-based reserving for life insurance products?
- **Group Issues:** Should the NAIC develop a model law to coordinate state efforts to act as group supervisors and should the NAIC approach supervisors in the European Union to discuss the creation of permanent supervisory colleges that could discuss the need for group-wide capital requirements?
- **Reinsurance Modernization:** The Reinsurance (E) Task Force should continue its work on reinsurance modernization and the project should be implemented as soon as possible;
- **Accounting Changes:** As the SEC considers whether to replace U.S. GAAP with IFRS, any replacement of GAAP with IFRS will necessitate re-codification of SAP. The NAIC also recognizes that any change in accounting standards would require modifications in solvency requirements, especially if the “total balance sheet approach” (already adopted as the IAIS standard) is adopted that recognizes the interdependence between assets, liabilities, regulatory capital requirements and capital resources; and
- **Economic Capital:** Insurance regulators would benefit from knowing a company’s calculation of its economic capital as well as how the company interprets and uses it.

**Group Supervision.** The **Group Solvency Issues Working Group** (GSIWG) of the SMITF is working to address improvements to the **Insurance Holding Company Model Regulatory Act (Model 440)** that have been suggested by state regulators and interested parties as a result of the economic crisis, as well as international initiatives for group-wide supervision.<sup>5</sup> Among the recommended changes to Model 440 that are under consideration are:

- adding provisions to enable or mandate international supervisory colleges;
- enhancing the confidentiality and other provisions in state law for purposes of sharing information among state, federal and international regulators (such as in international supervisory colleges);
- developing systemic risk factors for holding companies and affiliates on a group basis;
- expanding examination powers to clarify that the power of the Insurance Commissioner extends to the books and records of any affiliate for the purpose of determining the possible effect on the holding company system and the insurer;
- providing the Commissioner with the authority to require the immediate and/or the ultimate holding company of the insurer to maintain RBC of 300% at the insurer; and
- providing the Commissioner with the authority to stay or require written approval of any material transaction of the holding company and a non-affiliate that appears to have a detrimental financial impact on the insurer.

The Group Solvency Issues Working Group will hold an interim meeting to discuss the recommendations regarding the **Insurance Holding Company Model Regulatory Act (Model 440)** and a proposal then will be drafted and distributed to the Financial Condition (E) Committee and the SMITF.

**Sutherland Comment:** We note that the proposed changes to the **Insurance Holding Company Model Regulatory Act (Model 440)** should be focused on in conjunction with a number of developments at the federal level that call for expanded, consolidated supervision over financial services holding companies. For example, the Obama Administration's proposals for regulatory reform would provide for certain systemically important companies (including some insurance holding companies) to be subjected to consolidated supervision by the Federal Reserve. In addition, any insurance holding company that owns a bank or thrift would also be subject to oversight by the Federal Reserve. Finally, we note that the proposed federal charter bill, the National Insurance Consumer Protection Act, would grant significant powers to the Commissioner of National Insurance to examine and oversee not just the federally chartered insurer, but also all of its affiliates.

Also at the Summer Meetings, the GSIWG heard a presentation on international group supervision and solvency issues from the **ACLI International Solvency Committee**. The key messages from the presentation recognized the need to: (i) harmonize global solvency standards for insurance companies; (ii) develop a mechanism to assess and permit "equivalence" among regulatory bodies – i.e., to enter into mutual recognition agreements with foreign jurisdictions (presumably a future function of the ONI<sup>6</sup>); (iii)

<sup>5</sup> The European Union's Solvency II initiatives will require a foreign insurance company operating in one or more of its member states to be subject to supervision in the company's home country comparable to the supervision required in the EU.

<sup>6</sup> In its white paper "Financial Regulatory Reform – A New Foundation: Building Financial Supervision and Regulation" issued on June 17, 2009 (the "White Paper"), the Obama Administration called for the creation of the Office of National Insurance (ONI), which

create a common structure for the calculation of the main supervisory intervention points for groups; and (iv) develop a functional structure for group supervision that is effective and efficient (i.e., the supervisory colleges). The presentation concluded that group supervision will promote sound private insurance markets, yet will need to overcome legal and prudential challenges, and should not lead to another layer of supervision. The GSIWG set up a subgroup to work on Supervisory Colleges that intends to continue to study these issues in-depth and to have recommendations by the end of the year.

**International Accounting.** The **International Solvency and Accounting Working Group (ISAWG)** of the SMITF discussed the implications for insurers and regulators of the charge that the G20 has given to the Financial Accounting Standards Board (FASB) and the IASB to complete work on the Financial Instruments accounting standard by the end of 2009. This action will result in a new International Financial Reporting Standard (IFRS) that will replace IAS39, and in a series of new U.S. GAAP standards. In addition, the joint FASB/IASB Insurance Contracts accounting standard is expected to be exposed in the first half of 2010. As a consequence, insurers will not have drafts of these critical revised accounting standards to comment upon until mid-2010 at the earliest, with likely adoption in 2011. However, the International Association of Insurance Supervisors (IAIS) is intent on issuing a valuation standard by the end of 2010, which would require that the IAIS produce a draft standard on the valuation of assets and liabilities and make it available by the end of 2009 – before the accounting standard setters have completed their work. The ISAWG Group adopted a motion opposing finalization by the IAIS of any valuation standard and guidance papers on the valuation of assets and liabilities prior to the finalization of the converged IASB/FASB Financial Instruments and Insurance Contracts standards.

In addition, it was noted that the Financial Condition (E) Committee is developing a comprehensive document that will describe the U.S. solvency system and framework in one cohesive document to help convey the foundational concepts underlying the U.S. regulatory system to other countries, and also to provide a foundation for the NAIC to establish clear goals, priorities and long-term plans to modernize the U.S. solvency assessment framework.

## International Relations

The **International Insurance Relations (G) Committee** heard an update by NAIC President Commissioner Roger Sevigny on the examination of the U.S. financial sector (including insurance) being done by the International Monetary Fund (IMF) this fall under the **Financial Section Assessment Program (FSAP)**. A key component of the FSAP is an evaluation by the IMF of the extent to which the U.S. insurance regulatory system is consistent with the international standards embodied in the Insurance Core Principles of the IAIS. The FSAP also contains a quantitative analysis that assesses the impact of defined stress on the aggregate balance sheet of the insurance sector to detect the capacity of the sector to absorb macroeconomic shocks. Commissioner Sevigny stressed the importance of the FSAP by noting that “I can’t overstate its significance to the NAIC’s own self-reflection and improvement efforts.” Ian Tower from the IMF, who is conducting the review of the insurance sector, reported that the FSAP was kicked off in early June with a meeting with Treasury. During October, the IMF will do field work, talk with companies and industry representatives and trade organizations, and collect data. It will conclude its study next June or July with a report issued to regulators.

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would be empowered to “work with other nations and within the IAIS to better represent American interests, have the authority to enter into international agreements, and increase international cooperation on insurance regulation.” White Paper at 40.

The International Insurance Relations (G) Committee also discussed the NAIC's proposal that the IAIS develop a strategic planning task force, and noted the NAIC's support for the position taken by the major U.S. trade associations, including the ACLI and the American Insurance Association, in a letter to the IAIS President urging more openness in their processes, because the work of the IAIS will have a major influence on the U.S. insurance industry as the G20 pushes for more international convergence.

**Report on Supervisory Colleges.** The Committee also heard a report on supervisory colleges held to date, noting that the NAIC has participated in supervisory colleges for ING, AEGON, Zurich and Swiss Re and that it held the first supervisory college in the U.S. in April. Among the issues to be addressed with regard to the supervisory colleges are: the membership of the colleges, the format for the sessions and the agenda for the session, which can include a variety of items such as the strategy of the group, its capital situation, risk management process, internal control mechanisms, and corporate governance issues. Another major item for future discussion is the development of information sharing agreements, to ensure that regulators obtain sufficient information to make the supervisory college worthwhile. Another issue is to identify who is the lead regulator and what is its role in coordinating the process in relation to other regulators.

## Derivatives

**Derivative Use Plans.** The Executive Committee and the Plenary Session voted unanimously to adopt amendments to the **Derivatives Instrument Model Regulation (Model 282)**. Click [here](#) for a copy of adopted revised Model 282. The amendments grew out of a study that the Derivatives Market (E) Working Group began in 2005, which determined whether changes were needed to the NAIC model regulation. In light of the growth in the credit derivatives market, the Working Group concluded that, while the principal risk in credit derivatives is credit risk, other risks (documentation, settlement, legal, complexity and counterparty concentration risks) were specific to derivatives and unaddressed by the existing model regulation, and recommended a complete revision to Model 282. The Working Group found that derivatives, including credit default swaps, represent a significant portion of financial instruments available to insurers, so that public policy requires "uniform and robust" state regulatory oversight of this activity. The Working Group recommended that Model 282 be adopted as a national standard, despite the limited number of states that have adopted Model 282 at this time.<sup>7</sup>

Two primary changes were made to Model 282 by the Working Group. First, the model regulations requires companies to develop a **written derivatives use plan (DUP)**; and second, the DUP must be reviewed and approved by the Commissioner before the insurer can engage in derivatives transactions. As part of the DUP, Model 282 requires the insurer's **board of directors** to approve the written guidelines, methodology, policies and procedures and systems described in the DUP, determine whether the company has sufficient qualified personnel to implement the plan, review whether derivative transactions have been made in accordance with the plan, and take action to correct any deficiencies.

**Derivative Risk Mitigation Proposal.** The industry proposed that risk-based capital (RBC) calculations be adjusted to reflect the adequacy of an insurer's hedging strategy so that insurers that have effectively reduced their risks through hedging would be distinguished from those that have not. The ACLI has recommended categorizing hedging transactions into basic, intermediary and advanced hedging. RBC credit with regard to the hedging would be proportionate to the amount of risk reduced by the hedges – with 100% credit for basic hedging, and so on. Insurance regulators have many questions regarding the

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<sup>7</sup> To date, four states, California, Connecticut, Illinois and New York, have adopted MR 282.

proposal and will schedule a call of the Life Risk-Based Capital Working Group with the ACLI and other interested parties with a goal to have a proposal in place for 2010 RBC calculations.

## Climate Change

The **Climate Change and Global Warming Task Force** met again at the Summer Meeting. The Task Force followed up on the progress of its Climate Risk Disclosure Survey project. In that regard, the ACLI indicated that two of its member companies had agreed to participate in the survey. The Task Force also considered conducting a Climate Change and Global Warming Summit, possibly held in Washington, DC to coincide with the NAIC's Fall meetings. It remains to be seen whether such a Summit will be organized.

## Reinsurance

The **Reinsurance Task Force** continued discussions initiated at a previous meeting (a two-day meeting in New York on May 6-7) with respect to the Reinsurance Regulatory Modernization Framework. The Task Force spent significant time discussing comments on the draft federal bill (The Reinsurance Regulatory Modernization Act of 2009), separating issues into constitutional and non-constitutional issues. Constitutional issues include supervisory recognition, the ability of individual states to enter into agreements with foreign jurisdictions and non-governmental entities and the overall need for/ structure of federal oversight of the NAIC Reinsurance Supervisory Review Board (due to the delegation of federal authority).

With respect to non-constitutional issues, the Task Force discussed a variety of issues including, among others, the continuing role of the NAIC versus the aforementioned Review Board, protection of confidential information, solvent schemes of arrangement and dispute resolution mechanisms. The draft legislation is expected to be revised and re-exposed for comments.

The Task Force also discussed the NAIC Guidance Regarding Reinsurance Collateral Requirements (the "**Guidance Memo**"). The Guidance Memo is designed to provide support to insurance departments with respect to the allowance of additional forms of collateral to secure reinsurance obligations, including guidance on letters of credit. The view of the NAIC is that granting approval to additional types of collateral is not a permitted practice; rather, it is merely the exercise of authority already reserved to insurance departments under the Credit for Reinsurance Model Act. The Task Force voted to adopt the Guidance Memo and to distribute it to all jurisdictions.

Finally, the Task Force continued discussions on potentially reducing the minimum trusted surplus requirement in the Credit for Reinsurance Model Act. Since any changes to a model act must be approved in advance by the Executive Committee, the Task Force directed the staff of the NAIC to initiate the consideration process.

## Capital Adequacy

**Risk Charge for General Account Guarantees.** The **Financial Condition (E) Committee** deferred action on a referral from the Statutory Accounting Principles Working Group regarding the lack of risk charges for individual separate account products that are guaranteed by the general account. The issue is whether current risk charges adequately compensate the general account for risks taken through the guarantee of separate account products. The Statutory Accounting Principles Working Group had identified this as a "very concerning matter for solvency regulation." The Financial Condition (E) Committee will consider formation of a new group to address this issue during a future meeting.

**Capital and Surplus Relief Proposals.** In December 2008, the ACLI submitted proposals for capital and surplus relief, many of which have been resolved, but one of which is still in contention. The Life Insurance (A) Committee approved changes to the **Valuation of Life Insurance Policies Model Regulation** (Model 830) exposed on March 15, 2009 (removing constraints on X factors), to Actuarial Guideline 1c, and to **Actuarial Opinion and Memorandum Regulation** (Model 822), but held open for further consideration changes to **Model Regulation Permitting the Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserve Liabilities** (Model 815) to permit the retroactive recognition of preferred mortality tables for use in determining minimum reserves. The Capital and Surplus Working Group will have a joint call with the Statutory Accounting Principles Working Group (SAPWG) and LHATF to further consider the proposed changes.

**C-3 Phase III.** The **Capital Adequacy (E) Task Force (CADTF)** discussed the March 2009 report of the American Academy of Actuaries on **C-3 Phase III**, which evaluated the interest rate and market risk (C3) component of the current Life Risk-Based Capital framework in the context of products valued under a principles-based reserving approach. CADTF will schedule a call after the Summer Meetings to address the 11 comment letters it received on the report with a goal to finish its work by year end 2009, for adoption in 2010.

**Mortgage Experience Adjustment Factor (MEAF).** CADTF adopted a one year adjustment in MEAF for life 2009 RBC calculations, which changed the minimum factor to 75% and the maximum factor to 125%, as the ACLI works on a long-term solution to this issue. The industry raised the concern that the proposed short-term change in MEAF would cause companies to hold significantly more capital than under the current system for a one-year period, with future uncertainty on how to manage its portfolio of commercial and residential mortgage-based securities due to lack of clarity on any long-term changes in MEAF. If it appears likely that a long-term proposal will not be adopted in 2010, the CADTF will consider whether to extend or modify the short-term proposal.

**Treatment of Residential Mortgage-Backed Securities (RMBS) for Life RBC Purposes.** The life insurance industry is heavily invested in RMBS. With total invested assets of \$3.1 trillion in December 2007, RMBS comprised 15.1% or \$460 billion of invested assets. Moody's downgrade of \$260 billion of RMBS in February 2009 (\$100 billion to below investment grade) and again in April have been driven by models used by rating agencies. Consequence for the insurance industry of these downgrades is an automatic increase in required risk-based capital, because the RBC formula relies solely on ratings. Ratings, however, are downgraded at the "first dollar of loss" even if the severity of the loss to principal is not acute. The industry is proposing a change to RBC held for RMBS that will better reflect the risk of holding the securities for the long-term. The issue was referred to the Valuation of Securities (VOS) Task Force, which hopes to address the industry's proposal by year end.

**Downgrades in Monoline Insurers.** The report issued by the staff of the NAIC's Standard Valuation Office discussed the insurance industry's exposure to downgrades in monoline insurers that provide financial guarantees on invested assets. Insurers reported 2008 municipal exposure with a financial guaranty on a book value basis of \$144.6 billion and an associated fair value of \$139.6 billion.

## Statutory Accounting Developments

**Fair Value.** The Fair Value Subgroup of the SAPWG exposed for public comment *Statutory Issue Paper No. 138 – Fair Value Measurements*, that would adopt, with modifications, FAS 157, *Fair Value Measurements*, implemented through FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, into statutory accounting. Click [here](#) for a copy of Statutory Issue Paper No. 138.

The Fair Value Subgroup is aware that the IASB has recently exposed its own fair value guidance that includes important modifications to FAS 157. FASB is committed to reassessing FAS 157 in light of the new IASB guidance. The NAIC Fair Value Subgroup will continue to track IASB/FASB developments so that any actions by the NAIC are consistent.

**Other-Than-Temporary Impairments (OTTI).** The SAPWG directed its staff to write an interpretative paper on the development of a new SSAP with a very short exposure period in order to address complex issues regarding whether to fair value OTTI in debt securities. FASB Statement of Position FAS 115-2 and 124-2: Recognition and Presentation of Other-Than-Temporary-Impairments, issued on April 9, 2009, modifies current requirements that, to avoid recognizing an OTTI, an investor must assert that it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in its fair value to its amortized cost basis. Instead, the FASB believes it is more operational for an entity to assess whether the entity has the intent to sell the debt security or whether the entity more likely than not will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, the investor must recognize an OTTI. This is an issue of critical importance to many life insurance companies.

**GAAP Codification.** SAPWG set up a subgroup to recommend changes to the NAIC's Accounting Practices and Procedures manual in light the FASB Accounting Standards Codification that goes into effect on July 1, 2009.



*If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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