Summer 2003 NAIC Meeting Highlights

Presented below is Deloitte & Touche’s interpretive summary of selected committee and working group sessions of the Summer 2003 National Association of Insurance Commissioners’ (“NAIC”) meeting held June 21 – 24, 2003 in New York. We refer you to our publication titled NAIC Codification Update that was recently issued for an update of accounting matters discussed at this meeting.

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EXECUTIVE COMMITTEE AND PLENARY

Current Developments: The Executive Committee (“EX Committee”) adopted each of the following proposals:

- The Life Insurance Multiple Policy Model Regulation, which requires insurers to search for multiple policies on the same insured when a claim is filed on one policy;

- Amendments to the Title Insurance Agent Model Act, to make it consistent with the Gramm-Leach-Bliley Act (“GLBA”) with respect to controlled business provisions for entities other than depository institutions;

- Amendments to the Health Carrier Grievance Procedure Model Act and the Utilization Review and Benefit Determination Model Act, to bring them into compliance with the Department of Labor’s claims procedure rule in order to avoid federal preemption;

- Amendments to the Health Maintenance Organization Model Act, to add guidance on coinsurance provisions in managed care contracts, clarify solvency provisions, and add a new section related to downstream risk entities; and

- Amendments to the Health Carrier Prescription Drug Benefit Management Model Act, which provides standards to establish, maintain and manage prescription drug formularies and other pharmaceutical benefit management procedures used by health carriers that provide prescription drug coverage. In addition, the Prescription Drug Act establishes a medical exception process that would permit consumers to request a non-formulary prescription drug, or an exception to a dosage restriction or step-therapy requirement.

The EX Committee voted to forward the Market Conduct Record Retention and Production Model Regulation back to the Market Regulation and Consumer Affairs Committee to resolve an inconsistency in the timing of due dates for notices between the model and the Market Conduct Examiner’s Handbook. The Examiner’s Handbook contains a thirty-day notice requirement, but in the model there is a reference to a five-day requirement.

During an interim conference call, the EX Committee adopted new guidelines that require standing NAIC committees to perform regular reviews of adopted model laws. Since there are currently more than 260 model laws in effect, this process is expected to take several years. Since it is essential for these models to be as current as possible, the review will begin with the oldest models. Once a model is reviewed under this new set of standards, it will be reviewed again every 5 years. During the review process, committees will evaluate the original purpose of a model and consider the number of states that adopted it to assess whether the model is still relevant, requires amendments, or should be retained in its current state. This process will help produce more relevant and effective model laws.
During a joint meeting of the Casualty Actuarial Task Force ("CATF") and the Actuarial Opinion Instructions Working Group ("AOIWG"), the CATF adopted a final draft of the Property and Casualty Actuarial Opinion Model Law that was approved by the AOIWG during an interim conference call. Prior to adoption, changes were incorporated to address comments from the Information Sharing Working Group and interested parties. The CATF also adopted the related Annual Statement Instructions, which details the requirements for the appointed actuary to submit a Statement of Actuarial Opinion and an Actuarial Opinion Summary and describes confidentiality standards regarding actuarial workpapers obtained by regulators. The Statement of Actuarial Opinion will be a public document, while the Actuarial Opinion Summary and documents supporting that opinion will be considered confidential. If the Model Law passes through to Plenary during 2003, the CATF agreed to present a proposal at the March 2004 meeting of the Financial Regulation Standards and Accreditation Committee to recommend that the Model Law become part of the NAIC Accreditation standards.

The AOIWG adopted a draft response to the Statutory Accounting Principles Working Group that recommends parenthetical disclosures of non-tabular discounting related to unpaid claims, losses and loss adjustment expense reserves accrued on Lines 1 and 3 of Page 3 in the Annual Statement, rather than recording such amounts separately as a contra-liability. The AOIWG stated this would keep related reserves net of both tabular and non-tabular discounting, resulting in a stronger Actuarial Opinion.

The CATF reviewed the results of a general interrogatory detailing warranty business included in the NAIC financial data repository. The CATF indicated that warranty premiums made up approximately 7% of total premiums in 2002, but such amounts are not reported consistently among insurers. Reserves related to warranty business should be reported as Aggregate Write-ins, and reported under Other Liabilities in Schedule P of the Annual Statement. The CATF will continue to monitor premium volume for this line of business to consider whether such amounts should be reported separately.

The Terrorism Insurance Implementation Working Group ("TIIWG") discussed numerous implementation strategies to assist the Department of Treasury with regard to the Terrorism Risk Insurance Act of 2002 ("TRIA"). During several interim meetings, the TIIWG considered Treasury guidance related to insurer disclosures, the “make available” provisions, treatment of residual market mechanisms, possible expansion of TRIA requirements to group life insurance and personal lines, and the impact on TRIA if an insurer becomes insolvent.

The TIIWG also considered various issues raised by interested parties during interim conference calls. The Mortgage Bankers Association of America expressed concern that lenders are having difficulty obtaining information from mortgagees related to whether the business decided to accept the insurers’ offer to provide coverage for acts of terrorism. In addition, the American Academy of Actuaries ("AAA") requested the TIIWG to assist in evaluating ratemaking issues related to TRIA. The TIIWG will continue to help evaluate the many uncertainties remaining to help clarify legislation designed to mitigate the risk of loss to insurers resulting from future terrorist attacks.
During an interim conference call, the Property and Casualty Insurance Committee adopted a resolution for state insurance regulators to closely monitor the growth in the number of asbestos claims and lawsuits filed in recent years, and study the corresponding potential adverse impact on the insurance marketplace. Regulators shall continue regulatory oversight and take necessary actions to protect insurer solvency, preserve assets for impaired claims, and protect the interests of policyholders. Accordingly, regulators shall support effective federal and state legislation that resolves public policy issues associated with asbestos claims. This resolution was also adopted by Plenary during an interim conference call.

The Workers’ Compensation Task Force received the “State of the Line” report from the National Council on Compensation Insurance, which indicated overall workers’ compensation results improved during 2002, as frequency declined due to improved working conditions. However, if investment returns do not improve, underwriting results will diminish as the severity of medical claims continues to grow at double-digit rates.

The Crop Insurance Working Group received a report entitled, “Weather Financial Instruments: Insurance or Capital Markets Products”, which suggests that weather derivatives are simply insurance products disguised as non-insurance products to avoid state regulation. This misclassification causes purchasers to miss out on the benefits of state solvency and market oversight, while states forego revenue from premium taxes. The report also highlighted regulatory concerns when reinsurers offer weather insurance products as reinsurance products for energy providers, because rates and corresponding policy language for these products must be filed with state insurance regulators.

The Surplus Lines Task Force (“SLTF”) continued to discuss the appropriateness of allowing alien companies with U.S. branches to be included on the Quarterly Listing of Alien Insurers. A SLTF subgroup identified inconsistencies among states regarding the amount of funds that U.S. branches are required to hold in a trust. This subgroup will survey companies on the quarterly listing that have U.S. branches to obtain additional input.

The Multi-State Surplus Lines Bond Working Group (“MSSLBWG”) considered comments from interested parties regarding a proposal to establish a multi-state surplus lines bond. Opponents contend that the proposal should be discontinued, as it may violate the spirit of reciprocity requirements in GLBA. GLBA could preclude a non-resident state from asking whether such bonds exist. The MSSLBWG agreed this project should be discontinued, and voted to disband.

**LIFE INSURANCE AND ANNUITIES**

The Life and Health Actuarial Task Force (“LHATF”) held another discussion on proposed amendments to the Standard Valuation Law (“SVL”) to allow the Actuarial Opinion to be based solely upon the requirements of the insurer’s state of domicile, as requested by the Life Insurance and Annuities Committee (“the LIAC”). In a 4 to 3 vote, the LHATF voted that no changes should be made to the Standard Valuation Law related to the actuarial opinion. The LHATF formed a subgroup to consider other potential changes to the SVL during 2003.

The LHATF adopted the proposed actuarial guideline, *Guideline for Valuation Rate of Interest for Funding Agreements and Guaranteed Interest Contracts (GICs) with Bailout Provisions*. This guideline interprets requirements of the SVL for assignment of valuation interest rates to risks embedded in bailout provisions under funding agreements and GICs. Under the new guideline, bailout provisions shall be treated as a withdrawal by the policyholder at book value, and the underlying contracts shall be classified as Plan Type C per the model SVL (the policyholder may withdraw funds before expiration of interest rate guarantee in a single sum or installments over less than five years either (1) without adjustment to reflect changes in interest rates or asset values since receipt of the funds
by the insurance company, or (2) subject only to a fixed surrender charge stipulated in the contract as a percentage of the fund). If the contracts allow options other than paying out book value, the valuation actuary may use a valuation rate of interest higher than Type C, but such rate cannot be greater than that applicable to similar contracts without put or bailout provisions.

- The LHATF received a report from the AAA that addressed potential revisions to the *Standard Nonforfeiture Law for Individual Deferred Annuities* adopted by the EX Committee and Plenary at the Spring 2003 NAIC National meeting. One key concern is the development of guidance to determine lower nonforfeiture rates permitted for equity-indexed annuities, as the fixed 3% minimum nonforfeiture interest rate was replaced with a rate based upon the five-year Constant Maturity Treasury ("CMT") rate, less 125 basis points. The AAA report also raised concerns regarding the determination of the CMT rate applied, the potential effect the minimum crediting rate has on the CARVM reserve calculation, and inconsistencies with other regulations related to group and variable annuities. The LHATF will hold an interim conference call to address these issues.

- The LHATF held lengthy discussions regarding the appropriate application of Actuarial Guidelines XXXIII and XXXIV to reserve for the “dollar-for-dollar” guaranteed death benefit in variable annuities. This issue has proven to be a hot topic following the December 2002 Wall Street Journal article entitled “How Annuity Holders Can Pull a Switcheroo.” Since these benefits were not specifically addressed when the actuarial guidelines were promulgated, current authoritative guidance does not clearly describe the appropriate treatment. It is estimated that revisions to Actuarial Guidelines XXXIII and XXXIV could take 2 years to complete. The AAA agreed to develop a list of options for the LHATF to consider during an interim conference call.

- The LHATF reviewed a draft regulation that would require the use of the 2001 CSO composite ultimate mortality standards for credit life insurance. The LHATF continues to evaluate the appropriate application of the *Valuation of Life Insurance Policies Model Regulation* to credit life reserves, applicable floors for credit life reserves and requirements for non-single premium products. Since a quorum was no present during this discussion, the LHATF agreed to schedule an interim conference call to evaluate this issue further.

- The LIAC continued to discuss the proposed *Senior Protection in Annuity Transactions Model Regulation*, which outlines the supervisory responsibilities of an insurer to consider the insurance needs and financial objectives of senior consumers. Several comments from interested parties were incorporated into the draft regulation during an interim conference call. The LIAC hopes to adopt a final model regulation during the Fall 2003 NAIC National meeting.

- The *Variable Annuity Functional Regulation Working Group* ("VAFRWG") presented a report to the LIAC recommending that the sale of variable annuity products should be subject to heightened review of suitability standards by regulators, as commissions paid to agents selling variable annuity products are typically much higher than the commission paid to agents for the sale of investment products. Current standards for suitability type products set forth by the National Association of Securities Dealers ("NASD") apply to investment products but not insurance products. Securities regulators argue that these products are similar to mutual funds, which they have enforcement authority over at a state level, and that such products should be regulated under state law as securities. However, industry representatives contend that regulation by the Securities and Exchange Commission ("SEC"), the NASD and the state insurance regulators is sufficient, and that additional oversight by state securities regulators would be costly and unnecessary. The VAFRWG concluded that states should consider the best way to address enforcement of suitability standards (whether by the insurance regulator or the securities regulator).
The Viatical Settlement Working Group ("VSWG") continued discussion of amendments to the Viatical Settlements Model Regulation, focusing on changes to the Verification of Coverage Form that viatical settlement providers submit to insurers to confirm policy features. A subgroup was formed to reformat the appendix and incorporate a new Broker Reporting Form into the proposed regulation.

The Small Face Amount Working Group held a hearing to receive comments on a proposal to set limits on the maximum amount of premium insurers can collect on small face amount policies. Industry representatives and trade associations contend that such a cap would restrict the sale of policies to senior consumers and could limit the amount of benefits paid to beneficiaries if a policyholder dies after making only a few payments. Regulators and interested parties were asked to make a list of the issues to evaluate further at the Fall 2003 National NAIC meeting.

HEALTH INSURANCE AND MANAGED CARE

The Health Insurance and Managed Care Committee ("HIMCC") approved a regulatory alert bulletin to be sent to state insurance departments for distribution to stop loss carriers and third party administrators in their respective states. The alert urges insurers to review internal controls and business practices to ensure they don't become unwitting supporters of unlicensed health insurance plans, including certain multiple-employer welfare arrangements, professional employee organizations, or stop loss "reinsurance" with unlicensed health plans. The alert goes on to explain that such health plans are illegal if they claim to be exempt from ERISA requirements when they are not. In addition, stop loss coverage for employers located in one state issued or purchased through an out-of-state trust must include a filed and approved policy form. Finally, the alert states that companies that contract with illegal health plans may be subject to regulatory penalties and may be liable for all unpaid claims.

The HIMCC received an Issues Brief from AcademyHealth entitled Group Purchasing Arrangements: Issues for States, which identified cost savings available to companies that combine their purchasing power in group purchasing arrangements ("GPAs") to negotiate insurance rates lower than rates each would receive individually. However, this report encouraged state insurance departments to evaluate statutory laws applicable to GPAs to ensure those who rely on such arrangements are adequately protected. Consumers must rely on states to provide solvency protection for self-insured GPAs, as federal regulations may not be sufficient.

The HIMCC discussed a report from the Workgroup for Electronic Data Interchange ("WEDI") regarding compliance with HIPAA Transaction and Code Set ("TCS") standards. In a letter to the Secretary of Health and Human Services, the WEDI expressed concerns that a substantial number of covered entities are not ready to comply with HIPAA TCS standards by the October 16, 2003 deadline, and many providers and health plans would be forced to revert to paper submissions to avoid noncompliance. The WEDI urged the Secretary to consider a contingency plan to help mitigate unintended consequences and adverse impacts and outlined two recommendations. No response was available from the Secretary at the time of this meeting.

The Accident and Health Working Group ("AHWG") exposed revisions to the Standards for Disability Income Claim Reserves: Revisions to the Health Insurance Reserves Model Regulation for comment. These revisions are intended to clarify the circumstances under which disability income insurers may use their own experience in determining claim reserves. The new language clarifies that insurers can only use their own experience for termination rates applicable to periods within 2 years of disability (up to 5 years with the permission of the Commissioner).
The AHWG exposed revisions to the *Health Insurance Reserves Model Regulation* to incorporate modifications to active life reserve requirements for long-term care contracts. Proposed changes include specific provisions for adverse deviations in morbidity tables used, a ban against the use of morbidity improvement factors, authorization for lower lapse rates and a modification to the maximum mortality assumption. The AHWG also exposed revisions to the *Health Insurance Reserves Model Regulation* to clarify language related to single-premium credit disability reserves. However, the AHWG believes that these changes do not create or change existing guidance.

The AHWG exposed revisions to the *Health Reserves Guidance Manual* to conform to the requirements of INT 0221, *Accounting for Prepaid Loss Adjustment Expenses and Claim Adjustment Expenses*, which was adopted by the Emerging Accounting Principles Working Group in December 2002. Note that INT 0221 requires that liabilities for unpaid loss adjustment expenses and claim adjustment expenses shall be established at an amount necessary to adjust all unpaid claims, irrespective of payments made to third parties or administrators.

The Long-Term Care Working Group (“LTCWG”) discussed potential revisions to the *Long-Term Care Insurance Model Act* and *Long-Term Care Insurance Model Regulation*, based upon a detailed list highlighting differences between existing state laws or regulations and the current model. Common concerns were raised regarding the following: the definition of long-term care and whether riders must be held to the standards described in the *Long-Term Care Model Regulation*; consideration of premiums related to long-term care riders; and issues regarding guaranteed renewable or noncancellable policies and “maturity dates” for certain benefit reductions. The LTCWG will continue to evaluate issues identified during an interim conference call.

The Regulatory Framework Task Force (“RFTF”) discussed comments received on the issue paper *Issues Involving External Review Procedures*, which provides information about specific laws in states that have instituted a formal external review process to help resolve certain health care complaints. Currently, 43 states have enacted laws or regulations addressing external review. In addition, the RFTF discussed draft revisions to the related *Health Carrier External Review Model Act*, and exposed the draft for public comment.

The Coordination of Benefits Working Group (“CBWG”) discussed draft revisions to the *Coordination of Benefits Model Regulation* based upon numerous comments received from interested parties. Specifically, the CBWG discussed comments received on the section in the model that establishes rules for the order of benefits for dependent children. The CBWG also discussed comments received on a section of the model that outlines procedures for establishing a benefit reserve. Finally, the CBWG discussed the benefits of coordination between individual and group policies, and considered which type of policy would be primarily liable. The CBWG deferred decisions on whether to retain the benefit reserve provision and whether to allow individual and group coordination until it conducts a survey with state insurance departments to obtain additional information. The CBWG hopes to complete the survey and prepare a new draft to circulate for comment prior to the Fall 2003 NAIC National meeting.
**RISK-BASED CAPITAL**

- The Life Risk-Based Capital Working Group ("LRBCWG") adopted a proposal from the AAA to change the life risk-based capital instructions to incorporate risks associated with reinsurance assumed on workers’ compensation carve-out business. This proposal recommended the utilization of the existing property and casualty structure and RBC factors to the extent possible to maintain consistency. However, the Risk-Based Capital Task Force ("RBCTF") overturned this proposal, as industry representatives expressed concern regarding the methodology being used.

- The AAA recommended a change to the RBC instructions to address situations when contracts are sold as fixed annuities, but using variable annuity contract forms. Both regulators and interested parties expressed concern to expose this report, as there was confusion as to why variable annuities “sold as fixed” would be treated differently from other variable annuities with a fixed account. As a result, the LRBCWG requested the AAA to evaluate the need for consistent treatment for all variable annuities that have a fixed account. This issue will be considered further during the C-3 Phase II project.

- The LRBCWG received a report from the AAA on the status of the C-3 Phase II Project, which addresses the interest rate and equity risk associated with variable annuities with certain guarantees (not including index guarantees). The AAA recommended broadening the scope to consider other policy forms that offer guarantees (i.e., group annuity contracts with equity fund guarantees, variable life contracts with death benefit guarantees, including secondary guarantees), as well as variable annuities without guarantees. The AAA highlighted critical issues that are still being evaluated and discussed a work plan to finalize the project so recommendations could be incorporated in the 2004 RBC calculation. In addition, the AAA walked through sensitivity analyses included to highlight significant assumptions and explain the variation that could exist due to pricing, experience, product mix or duration.

- The LRBCWG adopted a proposal from the AAA to modify the life RBC formula for separate accounts that guarantee an index. Class I Strategies, which invest directly in the applicable index securities, should utilize a look-through method (i.e., general account C-1 factors would apply), while Class II Strategies, which utilize debt instruments, combined with index options, should use a tracking error method that measures actual experience. This change is effective for the 2003 RBC formula.

- The LRBCWG received a proposal from the AAA to modify the RBC instructions for modified coinsurance or funds withheld arrangements. This proposal would require a ceding company to exclude C-1 risks related to any asset whose performance inures primarily (>50%) to one reinsurer under modified coinsurance or funds withheld arrangement, while the reinsurer would include 100% of such assets. When no one reinsurer receives more than 50% of an asset performance, the C-1 risk should remain with the ceding company. The LRBCWG exposed this proposal, and also exposed changes to the RBC instructions to require the ceding company to provide adequate information to the assuming company to enable it to determine the amount of RBC assumed.

- The LRBCWG received a report from the AAA related to an analysis performed for long-term care products. The report highlighted a significant difference in modeling results for large blocks (> $75 million direct earned premium) and small blocks (< $75 million direct earned premium). In addition, the report suggested that a significant portion of the long-term care solvency risk is more appropriately related to the level of claims than the premium volume. Due to time constraints, the LRBCWG agreed to hold an interim conference call to evaluate how to proceed. The Risk-Based Capital Task Force ("RBCTF") subsequently determined that any increase in the factors related to long-term care business should apply to all long-term care business, not just large amounts of such business.
The Property and Casualty Risk-Based Capital Working Group ("PCRBCWG") adopted underwriting factors for the 2003 RBC formula. In addition, the PCRBCWG agreed to eliminate the reduction of credit risk attributable to participation in certain voluntary pools and the exemption to gross written premiums for servicing carriers. Both portions of the formula seem to cause a great deal of confusion with insurers who commonly misapply the formula. NAIC staff evaluated the impact of both changes, providing an analysis that compiled their results and indicated that there would not be a significant change in RBC for any of the companies evaluated. As a result, the PCRBCWG adopted the following language for the Overview and Instructions to clarify that companies should not reduce the gross written premiums for the growth charge for participation in residual market mechanisms:

"DO NOT DEDUCT PARTICIPATION IN RESIDENTIAL MARKET MECHANISMS. However, an adjustment is required for carriers that are servicing carriers for an assigned risk mechanism. Those carriers shall exclude gross written premiums from serviced involuntary pool business ceded to such pool(s) for any of those years. That adjustment for the company and for the group must be entered on the appropriate lines in the program."

The Ad Hoc Subgroup unexpectedly adopted a proposal to change the factor used to calculate the Authorized Control Level RBC in the property and casualty RBC formula from 50% to 75%, and exposed this amendment for a sixty-day comment period. This increase may force some companies to trigger regulatory action that had not triggered an RBC level event before. Such an increase was not deemed necessary for the life RBC formula, as research indicated that relatively few additional companies would trigger regulatory action if the ACL was increased. In addition, an increase was not recommended for the health RBC formula, as the Ad Hoc Subgroup felt the health requirement was too new and data could be unreliable.

The Ad Hoc Subgroup requested the AAA to consider whether the results of a life RBC trend test appear to be appropriate and to evaluate the viability of implementing a trend test for the property and casualty and health RBC formulas. If such a trend test is considered viable in the property and casualty and health RBC formulas, the AAA was asked to suggest an appropriate structure for the trend tests.

The RBCTF referred a proposal to the LRBCWG to consider amendments to the RBC formula by establishing an offset equal to 50% of additional contract reserves, up to the full amount of underwriting risk. This proposal suggests that the RBC treatment for additional contract reserves should be consistent with premium stabilization reserves, as both reserves allow states to utilize the related assets set aside to pay claim costs during a liquidation. Note that the annual change in premium stabilization reserves is excluded from underwriting risk. Furthermore, 50% of premium stabilization reserves held as a liability are permitted as an offset up to the full amount of underwriting risk in RBC. The LRBCWG shall evaluate whether any changes to the RBC formula are warranted.

**VALUATION OF SECURITIES**

The Invested Assets Working Group ("IAWG") continued to discuss a proposal to require certain Schedule BA investments that have underlying characteristics of bonds or other fixed income instruments to be filed for credit analysis with the SVO. The IAWG requested SVO staff and interested parties to report on the following three issues during the Fall 2003 NAIC National meeting:

1) The impact on the asset valuation reserve, risk-based capital and the Schedule BA Annual Statement Instructions;

2) The need to amend Schedule BA to add fields to include an NAIC designation; and
3) The appropriate scope of the proposal and whether it applies to both life and property and casualty companies.

- The IAWG agreed to support a Form A to allow insurers to report money market mutual funds listed on the U.S. Direct Obligations/Full Faith and Credit Exempt List and the Class 1 List as cash equivalents. Proposed changes to the Securities Valuation Office Purposes and Procedures Manual (“SVO P&P Manual”) were referred to the Securities Valuation Office Oversight Working Group (“SVOOWG”) for approval. The SVOOWG subsequently adopted the proposed changes effective December 31, 2003, pending adoption of the related Form A by the Statutory Accounting Principles Working Group.

- The IAWG continued to review a proposal to assess the appropriate treatment of exchange traded fund securities known as I-Shares. These securities are SEC-registered index funds with shares representing ownership interests in an underlying pool of bond securities. Interested parties provided a report highlighting the differences between I-Shares and traditional mutual funds, and recommended that such securities be characterized as bonds for accounting purposes and RBC treatment. The IAWG agreed that I-Shares have enough unique characteristics that they should not be classified as mutual funds, and directed SVO staff to evaluate I-Shares as bonds and report back on the appropriate treatment on Schedule D and for RBC purposes. In addition, the IAWG directed SVO staff to create a new list in the appendix of the SVO P&P Manual to describe such securities for regulators.

- The IAWG exposed a report on the accounting treatment and appropriate RBC capital factor for Affordable Housing Tax Credit Partnerships (“AHTCP”). AHTCP investments are generally valued based upon the underlying GAAP equity of the limited partnership, as required by SSAP No. 48, Joint Ventures, Partnerships and Limited Liability Companies. As these investments are typically very predictable, with a low number of defaults, few foreclosures and limited market value fluctuations, interested parties contend that such investments should be amortized in proportion to the utilization of tax benefits allocable to the investor for a particular AHTCP investment. Interested parties may submit written comments prior to the July 25, 2003 deadline.

- The Securities Valuation Office Oversight Working Group (“SVOOWG”) adopted the following two initiatives set forth in a New York proposal to reform the SVO filing and rating process, with a contingency that the SVO office must first achieve “revenue neutrality”:

  1) Eliminate the filing requirement for all securities that have received a rating from a nationally recognized statistical rating organization (“NRSRO”) that is equivalent to an NAIC 1 or 2 designation;

  2) Establish an annual agenda for the SVO’s Research Unit, based on the projects that state regulators feel are important. Such research could include evaluation of investment trends to help identify and understand financial risks.

The concept of revenue neutrality relates to alternative methods that can be utilized by the SVO to offset the estimated $2.8 million in filing fees for NAIC 1 or 2 designation securities budgeted for 2004 that will not be received. This decrease stems from a projected 87% decline in filing volume. The Revenue Consideration Working Group (“RCWG”) is currently evaluating the following three alternatives to recover the lost revenues resulting from the filing exemption:

  1) Revise the filing fee structure to increase the fees on non-rated filings that will continue to be filed with the SVO;

  2) Charge an aggregate assessment to insurers, or
3) Create a blended approach that incorporates a filing fee structure for non-rated filings and an aggregate assessment for all insurers.

The RCWG will continue to analyze these options and prepare a recommendation to the Internal Administration Subcommittee (“the Subcommittee”) in the coming months. From there, the Subcommittee and the Financial Condition (E) Committee will conduct a joint hearing to consider regulator and industry comments on both the filing exemption and fee structure proposals before presenting a final recommendation to the Executive Committee at the Fall 2003 NAIC National meeting. The ultimate goal is to adopt both proposals with a January 1, 2004 effective date.

The SVOOWG also discussed the following long-term goals from the New York proposal:

1) Eliminate the filing requirements for all securities rated by NRSROs with the equivalent of an NAIC 3 – 6 designation; and

2) Allow companies to self-rate unrated securities when established standards for rating/valuing securities are met.

Although these initiatives have generated significant support from interested parties, regulators are reluctant to pass such radical reforms without additional consideration. NAIC designations are not always consistent with NRSRO ratings. The SVOOWG requested additional time to evaluate the procedures performed by the SVO regarding securities with a 3 – 6 designation, as well as unrated securities. Interested parties contend that the long-term proposals actually provide a more efficient approach to analyzing credit risk. The SVOOWG will continue to evaluate concerns raised by regulators, including potential impacts on the examination process, and evaluate possible implementation methods.

- The SVOOWG adopted a proposal to delete the definition of statement value in the SVO P&P Manual to eliminate the correlation between unit price and statement value, as this definition was inconsistent with the definition of statement value in the NAIC Accounting Practices and Procedures Manual.
- The SVOOWG directed SVO staff to work with interested parties to update Section 14 of the Appendix to the SVO P&P manual to incorporate all government securities backed by the full faith and credit of the U.S. government, as listed in Section 16 of the Appendix. Section 14 is currently comprised of a mix of securities including some full faith and credit securities, Freddie Mac, Fannie Mae, Farmer Mac and Federal Home Loan Bank securities. Note that Section 14 is used for asset valuation reserve and RBC exemption and Schedule D reporting, while Section 16 is used for SVO filing exemption.
- The SVOOWG discussed whether the SVO should provide written explanations regarding adverse decisions for an appeal. Due to resource constraints, the SVO is apprehensive to provide such responses in writing. However, interested parties cited numerous reasons that written responses should be provided (i.e. provides a common record that can be utilized in more than one circumstance; it provides future reference regarding the thought process if turnover occurs; it does not provide any potential liability, as liability would stem from action; one state has a provision within its laws that requires final orders affecting substantial interests to be in writing). In addition, interested parties content that a 90-day limitation on the time period to submit an appeal is not justified, and such a requirement could force insurers to incur additional costs. Due to time constraints, the SVOOWG did not vote on this proposal. The SVOOWG will hold an interim conference call to discuss these issues in more detail.
- The SVOOWG heard a progress report on the recognition of Dominion Bond Rating Service as an NRSRO under the SVO P&P Manual. The SVO is preparing a cost/benefit analysis to evaluate the feasibility of moving forward with this proposal, as additional costs would be incurred to integrate data feeds. The SVOOWG intends to hold an interim conference call to finalize a recommendation.

NAIC/AICPA

- The NAIC/AICPA Working Group (“NAIC/AICPA WG”) adopted a revision to the Model Audit Rule to strengthen the auditor’s consideration of procedures in Section 9, Scope of Examination and Report of Independent Certified Public Accountant, of the NAIC Financial Condition Examiner’s Handbook. While AICPA representatives expressed their support for increased communication with regulators, they reiterated it would not require auditors to perform procedures from the Examiner’s Handbook that they would not have otherwise performed as part of a GAAS audit. This change to the Model Audit Rule will be adopted in Plenary before a Blanks Proposal is made.

- The NAIC/AICPA WG adopted proposed revisions to the Annual Audited Financial Statements section of the Property and Casualty Annual Statement Instructions regarding coordination between the appointed actuary and auditors. These revisions would require auditors to subject the significant data used by the appointed actuary to testing procedures, thereby increasing communication between auditors and actuaries regarding loss data relied upon. Representatives from the CATF expressed their support for greater communication; however, the AAA cautioned that actuaries rely on data supplied by others and are not involved in the design of the audit process. The AICPA will work to amend the guidance in Statement of Position 92-4, Auditing Insurance Entities’ Loss Reserves, and develop protocols for coordination between management, the appointed actuary and the auditor. An Annual Statement Instructions Proposal will be forwarded to the Blanks Task Force for consideration its next meeting. If adopted as expected, this requirement would be effective in 2004.

- The NAIC/AICPA WG adopted revisions to the Consideration of the Use of CPA Workpapers section of the Examiner’s Handbook proposed by the subgroups established to address concerns raised in the Use of CPA Workpapers Survey. The revisions set forth general guidance to help improve communication and understanding between examiners and auditors. Significant recommendations include the following:

1) The materiality threshold for consolidated audits will be higher than that used for stand-alone audits. As a result, the examiner may need to perform additional testing for stand-alone entities.

2) Formal communication between auditors and examiners should take place during the planning phase of the examination to facilitate greater reliance on the work performed by auditors.

3) The NAIC should develop education programs to describe the interrelations between a financial examination and an audit. In addition, the AICPA should develop an informational handout for auditors that provides an overview of the Examiner’s Handbook and the financial examination process.

In addition, a list of preferred procedures from the Examiner’s Handbook that regulators would like auditors to perform and document was provided by each subgroup to help create examination efficiencies. Proposed revisions to the Examiner’s Handbook will be forwarded to the Financial Examiner’s Handbook Technical Group for their consideration. At that time, the proposal will be exposed to interested parties for comment.
The NAIC/AICPA WG received a report from AICPA representatives regarding technical projects that may affect state insurance regulators and the insurance industry:

**Non-Traditional, Long-Duration Contracts**: AcSEC will issue SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Non-traditional, Long-Duration Contracts and for Separate Accounts*, in early July 2003, with the SOP being effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged;

**DAC on Internal Replacements**: In March 2003, AcSEC issued an exposure draft of a proposed SOP, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other than those Specifically Described in FASB Statement No. 97*. AcSEC discussed comments received during its June 2003 meeting, and will address recommendations for any revised methodologies or approaches for the SOP during its July 2003 meeting;

**Separate Account Financial Highlights** – In May 2003, AcSEC approved for exposure the proposed SOP, *Financial Highlights of Separate Accounts – An Amendment of the Audit and Accounting Guide Audits of Investment Companies*, subject to FASB clearance. The SOP will address the application of certain provisions of the AICPA Audit and Accounting Guide, *Audits of Investment Companies*, specifically reporting financial highlights by separate accounts. AcSEC plans to issue an exposure draft SOP in early July 2003 with a 60-day comment period.

**RISK ASSESSMENT**

- The Risk Assessment Working Group (“RAWG”) heard a presentation from a Big Four accounting firm on the Sarbanes Oxley Act (“Sarbanes Oxley”) and its impact on the risk assessment framework. The RAWG hopes to leverage off Sarbanes Oxley requirements and other corporate governance standards (e.g., COSO) to complete their risk assessment framework. A consultant also gave a presentation that addressed how risk assessment can enhance the examination process.

- The RAWG and the Legislative Section of the CPCU Society hosted a panel discussion on Sarbanes Oxley to address management’s enhanced responsibilities regarding corporate governance. Potential impacts on the insurance industry, including private entities and not-for-profit organizations, were discussed, as individuals acknowledged that certain requirements of Sarbanes Oxley may be adopted by Board members of non-public companies who want to enhance their corporate governance process.

- The Risk Prioritization Subgroup (“RPS”) continues to analyze FAST ratios and scoring systems used in Minnesota and Ohio to determine the most useful and predictive ratios to incorporate into a single standardized prioritization system used in the insurer profile. The RPS will hold a pilot project to evaluate the effectiveness of a prototype based upon the Minnesota scoring system. The ratios will then be mapped to the CARRMELS prioritization categories (which measure the risk profile of an insurer in terms of Capital adequacy, Asset quality, Reserves, Reinsurance, Management, Earnings, Liquidity, and Sensitivity). The RPS exposed preliminary recommendations regarding the appropriate scoring system to utilize for the capital adequacy ratios for property and casualty insurers for comment. Future conference calls will be held to develop recommendations on the remaining CARRMELS categories and evaluate best practices that could be used by regulators for additional subjective analysis.

- The Risk Assessment Development Subgroup reported that an exposure draft regarding the appropriate framework to perform a risk assessment would be released for comment in July 2003.
The **Information Sharing Working Group** ("ISWG") proposed the following three solutions to maintain risk assessment workpaper confidentiality:

1) Revise the Examiner’s Handbook to expressly reference risk assessment documents, which then become protected under Section 5F(1)(a) of the Model Law on Examinations;

2) Revise the Model Law to explicitly broaden the scope of protected documents to include risk assessment materials; or

3) Develop risk assessment-specific confidentiality language that individual states could enact.

Commissioner Terri Vaughan requested the RAWG subgroups work to incorporate the ISWG’s recommendations into the Examiner’s Handbook to ensure that the risk assessment work is maintained as a confidential document.

**UNDERWRITING AND REINSURANCE**

The **Reinsurance Task Force** ("RTF") continued to discuss the proposal to reduce the 100% collateral requirement for unauthorized reinsurers when a reinsurer meets certain requirements and is placed on an Approved Reinsurer List. The RTF received a report from the Chair of the Insolvency Task Force indicating it does not support a reduction in collateral requirements, as the lack of collateral could impact creditors, guaranty funds and potentially policyholders in the case of insolvency. In addition, the RTF reviewed a memo from current NAIC officers that quantified the additional credit risk to U.S. ceding insurers if all top tier non-U.S. reinsurers (rated at least A by Standard and Poor’s) to be $24.7 billion. A representative for the alien reinsurers noted that this only represents 3% of total assets for these ceding insurers. Finally, the RTF discussed comments letters addressing the potential financial impact of an approved reinsurer listing, enforceability of U.S. judgments abroad, and impacts of international accounting standards. The RTF will continue to evaluate this issue in an attempt to reach “some agreement” on this issue.

The RTF also continued discussions on the regulation of reinsurance in non-U.S. jurisdictions, and received final reports for Germany and the United Kingdom. The deadline for written comments on the jurisdictional reports is July 31, 2003.

The **Property and Casualty Reinsurance Study Group** ("PCRSG") discussed a draft interrogatory change to Schedule F – Part 5 to consider incurred but not reported ("IBNR") amounts due from unauthorized reinsurers. NAIC staff noted that some insurers are including the IBNR in Schedule F – Part 3 but excluding it from Schedule F – Part 5, thereby reducing the Schedule F penalty. Interested parties contend that nonadmitting such amounts could cause a hardship for companies, and recommended that such amounts be disclosed. Note that the difference results from an instruction that permits exclusion for amounts recoverable under reinsurance contracts that were not in force July 1, 1984, however NAIC staff believes this exclusion is being misapplied by many insurers and may no longer be valid. The PCRSG will hold an interim conference call to finalize a Blanks proposal to be considered by the Blanks Task Force at the Fall 2003 NAIC National meeting.

The PCRSG continued to discuss syndicated letters of credit ("LOC") and whether each member of a syndicate should have a separate LOC. A comment letter supporting syndication explained that a syndicated letter of credit ("LOC") does not expose a beneficiary to any risk not present in an individual letter of credit structure, and that syndicated LOCs are widely recognized and accepted letters of credit. However, the California Insurance Department contended that the form of such letters does not meet California Insurance Code requirements, which may lead to problems during a liquidation proceeding. It recommended that the syndication agreement be revised to permit the agent
The PCRSG agreed to draft a Form B to the Emerging Accounting Issues Working Group to clarify that retroactive accounting treatment shall not apply to intercompany reinsurance agreements, including portfolio transfers, pooling arrangements or any amendments thereto, among companies 100% owned by a comment parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction.

The RCRSG adopted a proposal to amend the annual statement instructions to clarify that negative balances should not be included in Column 11 of Schedule F – Part 6, Provision for Overdue Authorized Reinsurance, as such amounts inappropriately reduce the Schedule F provision. In addition, the RCRSG adopted changes to Notes 22A and 22B to indicate that unsecured reinsurance should be net of funds held, but reinsurance in dispute should not be net of funds held. Finally, the RCRSG adopted a proposal for the annual statement instructions to explicitly state that intercompany reinsurance should be recorded with other reinsurance in Schedule F, and not part of intercompany payables or receivables.

Lastly, the RCRSG discussed whether state insurance departments could enforce provisions in the NAIC Financial Condition Examiner’s Handbook if the states do not require, through statute or bulletin, the use of the Examiner’s Handbook. This question arose during consideration of an intermediary article, which states that credit will not be allowed to a ceding company for reinsurance cessions under contracts incepting on or after January 1, 1980, where payments are made via an intermediary unless the reinsurance agreement includes a provision whereby the reinsurer assumes all credit risk of the intermediary related to the payments of the intermediary. The RCRSG will continue to evaluate this issue.

GRAMM-LEACH-BLILEY ACT (“GLBA”) UPDATE

As the Privacy Issues Working Group’s (“PIWG”) goal is to reach common conclusions on interpretation issues with respect to the NAIC model privacy regulation, it spent the majority of its meeting considering a question presented at the Spring 2003 NAIC National meeting. The question raised was, “May a licensee share a claimant’s non-public personal health information with its insured under a commercial general liability policy?” Respondents generally indicated that the insured entity should only have reason to obtain non-public information if there is a lawsuit or administrative proceeding, so it could successfully defend itself or determine damages. However, no final conclusion was adopted regarding this matter.

The PIWG reported that there have not been any new states that have adopted the privacy model regulations. The PIWG will begin drafting a list of frequently asked questions regarding issues considered during privacy exams to ensure such matters are resolved in a consistent manner.
SPEED TO MARKET

- The NAIC’s commitment to reduce the time and cost of filings continues to improve, with the increased use of the **System for Electronic Rate and Form Filing** (“SERFF”), an electronic-based rate and form filing system that utilizes web technology. Insurers have processed more than 29,000 rate and form filings electronically during 2003, with an average turnaround time of 17 days. SERFF has multi-state filing capabilities with uniform transmittal standards. The NAIC has established a goal to have all states accept all rate and form filings via SERFF, for all lines of insurance and all filing types, by December 31, 2003.

- The **Improvements to State-Based Systems Working Group** (“ISBSWG”) demonstrated the Property and Casualty Product Requirements Locator and the recently added Life and Health Product Requirements Locator. These locators are searchable web-based databases that allow insurers to query state requirements by product and requirement categories to design compliant filing forms more efficiently.

- The ISBSWG’s Review Standards Checklist Subgroup announced a “Speed to Market Self Certification” pilot program to assist in streamlining the filing review and approval and/or acknowledgement process. The pilot program and pilot states were identified and described. It is anticipated that this program will continue to expedite insurance department reviews of form filings.

- The **National Treatment and Coordination Working Group** (“NTCWG”) discussed goals to further streamline the licensing process by evaluating the Uniform Certificate of Authority Application to identify elements that are either unnecessary or available through other means (e.g., I-SITE), develop minimum standard review procedures and evaluate causes of delayed actions on licensing applications. The NTCWG addressed the need to focus on standardizing licensing requirements, as requirements are widely diverse related to the need for examination reports, name approval and fingerprinting, as well as the amount of minimum statutory deposits.

EXAMINATION OVERSIGHT

- The **Examination Oversight Task Force** (“EOTF”) was expected to release a revised version of the *Recommendations in Response to the Statutory Financial Examination Process White Paper “A Call for Change”* (“the Final Recommendations Report”), but the Chair indicated that this document is not ready for public exposure. The EOTF continued discussions during an executive session and will hold interim conference calls with the hopes of exposing the document during the Fall 2003 NAIC National Meeting.


INTERNATIONAL ACCOUNTING STANDARDS

The **International Accounting Standards Working Group** (“IASWG”) received an update on current activities of the International Accounting Standards Board (“IASB”) regarding the Insurance Contracts Project. The IASB adopted a “Sunset Clause” to remove the Phase I hierarchy exemption if Phase II has not been completed by January 1, 2007. The Phase I exposure draft should be released by the end of July 2003. Phase II of the Insurance Contracts Project has been halted until the IASB agenda becomes more manageable. As a result, the IASB will evaluate projects that have evolved for more
than 2 years without producing formal documentation to determine whether they should be removed from the agenda.

The IASWG noted a new international accounting web page that has been added to the NAIC website to link users to IASB updates.

**OTHER**

- **The Blanks Task Force** ("BTF") adopted a proposal to significantly revise the procedures for adopting changes to the Blanks and Instructions. Effective January 1, 2004, the BTF will adopt such proposals throughout the year rather than only once each year. In addition, the BTF discussed the implications of charging a $10 fee per download for insurers who want to access annual statement data in .pdf format on the Consumer Information Source database on the NAIC website. Regulators expressed concern that insurers who previously had free access to this information will now request it from the states. In addition, there was concern that decision to implement this charge was not approved at a public meeting. The BTF will draft a letter to the RCWG to address these concerns and ask for clarification.

- **The Arbitration Issues Subgroup** ("AIS") of the **Consumer Protection Working Group** ("CPWG") held a public hearing to continue discussions regarding the inclusion of arbitration clauses in insurance contracts. Although opponents contend arbitration clauses could result in higher costs to consumers or inadequate information for consumers, there was agreement that such clauses should only be enforceable if the agreement is voluntary and the agreement to arbitrate is made after the dispute arises. As a result, the AIS recommended language to the CPWG that incorporated these requirements. The CPWG will evaluate the proposed language to determine whether it complies with appropriate regulatory standards.

- **The Custodial Assets Working Group** ("CAWG") approved an Issues Paper which recommended an amendment to the NAIC Model Act to allow broker/dealers to act as custodians for insurance company assets, with certain minimum eligibility standards. The CAWG concluded that broker/dealers are regulated and hold securities in the same manner as banks, and the Securities Investor Protection Corporation has an excellent track record of returning assets in the case of broker/dealer insolvency. In addition, both Arkansas and Texas have had success with their practice of allowing broker/dealers to act as custodians. The Financial Condition Committee subsequently adopted a motion to expose the Issues Paper for comment and a proposal to allow broker/dealers to act as custodians. This will be discussed further at the Fall 2003 NAIC National meeting.

- **The Insurance Holding Company Working Group** ("IHCWG") finalized two surveys designed to evaluate the nature and extent of coordination occurring between multi-state Form A filings and financial condition examinations. This information will be used to facilitate coordination among states involved in Form A filings to allow companies to complete acquisitions quicker. The IHCWG also discussed methods to coordinate the review of Form D filings among multiple states to ensure reviewers are aware of issues identified by other states.

- **The Insurance Securitization Working Group** ("ISWG") discussed comments from the Insurance Securitization Technical Assistance Working Group of the CATF regarding proposed procedures to review the Plan of Operation filed to create special purpose reinsurance vehicles or protected cells. Such comments addressed recommendations to consider investment guidelines regarding the quality of investments, interest rate sensitivity, liquidity, and diversification of the portfolio. In addition, regulators should evaluate the probability of the contract being triggered over the life of the contract and the magnitude of the exposure being hedged. The Chair of the ISWG recommended that the comments received should be incorporated into a new draft of procedures to create a uniform insurance securitization review policy for consideration at the Fall 2003 NAIC National meeting.
The ISWG also exposed the *Issues Paper on Life Insurance Securitization*, which recommends that an ISWG subgroup evaluate how a life securitization that transfers insurance risk should be recorded. Regulators and interested parties were asked to comment whether any proposed changes to state regulations or model acts were needed to facilitate life insurance securitizations.

- The **Rating Agency Working Group** ("RWG") held an open forum with representatives from various rating agencies to gain a better understanding of methodologies used by rating agencies and address current market conditions. The RWG asked representatives whether rating agencies could enhance the regulatory process by communicating significant rulings to regulators on a timely basis. Representatives from the rating agencies indicated that insurers should provide the link between the rating agency and the regulator, as mandatory communication with regulators could impede the timely issuance of future ratings. In addition, such communication could jeopardize their ability to be regarded as an independent evaluator. Representatives acknowledged that they generally do not consider the actions of regulators with regards to a specific company, although they would consider regulatory actions on the industry as a whole.

- The RWG discussed SEC Concept Release 33-8236, *Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws*, which questions whether the SEC should rely on NRSRO designations determined by ratings agencies, and the level of regulatory oversight needed if used. The RWG discussed possible effects of the SEC eliminating the NRSRO designation. Interested parties can access the concept release on the SEC website at [www.sec.gov](http://www.sec.gov). Comments on the concept release are due July 28, 2003.

THIS SUMMARY DOES NOT REPRESENT THE OFFICIAL MINUTES OF THE NAIC. In preparing this summary we have attempted to accurately report developments at the Summer 2003 NAIC National meeting. However, the information contained herein may differ from the actual NAIC minutes and the final actions of the NAIC.

This summary was contributed by Aimi Daniel, Senior Manager, Deloitte & Touche National Insurance.