

Case No. 10-3991

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

AMERICAN FINANCIAL GROUP AND CONSOLIDATED
SUBSIDIARIES,

Plaintiffs-Appellees

v.

UNITED STATES OF AMERICA,

Defendant-Appellant

Appeal from the United States District Court
for the Southern District of Ohio

**BRIEF *AMICUS CURIAE*, NATIONAL ASSOCIATION OF
INSURANCE COMMISSIONERS, IN SUPPORT OF APPELLEES
AND AFFIRMANCE OF THE DISTRICT COURT DECISION**

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1, *Amicus Curiae*, National Association of Insurance Commissioners (“NAIC”), is a non-profit corporation organized under the laws of the State of Delaware. The NAIC operates under § 501(c)(3) of the Internal Revenue Code. It has no parent corporation and, as it has no stock, no publicly held company owns 10% or more of its stock.

MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF

Counsel for Appellees has consented to the filing of the NAIC’s *amicus* brief in this case, but Counsel for Appellants has not given consent. Filed along with this Brief is the NAIC’s Motion for Leave to File *Amicus Curiae* Brief.

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I. IDENTITY AND INTEREST OF AMICUS CURIAE

The National Association of Insurance Commissioners (“NAIC”) is a non-profit corporation whose membership consists of the principal insurance regulatory officials of the fifty States, the District of Columbia, and the territories and insular possessions of the United States. Founded in 1871, it is the nation’s oldest association of state government officials. The NAIC represents the coordinated and considered views of the state government officials that regulate the insurance industry and enforce the insurance laws of the country.

The NAIC’s purpose is to provide its members with a national forum enabling them to work cooperatively on regulatory matters that transcend the boundaries of their own jurisdictions. Collectively, the state insurance commissioners work to develop model legislation, rules, regulations, bulletins, white papers, handbooks, manuals and actuarial guidelines that promote and establish uniform regulatory policy. In addition, the NAIC manages and coordinates the accreditation review of insurance departments as well as maintains regulatory and financial databases of insurance company financial data. The overriding objective of the NAIC is to protect consumers as well as assist in maintaining the financial stability of the insurance industry.

The interest of the NAIC in this case arises out of the interpretation of NAIC Actuarial Guideline XXXIII “Determining Minimum CARVM Reserves for

Individual Annuity Contracts” (“AG 33”)¹, which is the central issue of this litigation. As the body drafting and adopting AG 33, the NAIC members are uniquely qualified and situated to assist this Court by presenting the regulatory and public policy concerns involved in this case.

The NAIC clearly has an interest in the interpretation of its model laws, regulations and actuarial guidelines, and in promoting the uniformity of these laws, regulations and actuarial guidelines among the states. The NAIC Executive Committee, in accordance with NAIC procedures, has voted to file an *amicus curiae* brief in this matter. The NAIC endorses the brief of Plaintiff-Appellants, and its legal arguments. We seek to aid this Court by offering the legal position and public policy perspectives of our national association and NAIC member states.

II. STATEMENT OF THE CASE AND STATEMENT OF FACTS

The NAIC agrees with and incorporates by reference the Statement of the Case and Statement of Facts of Plaintiffs-Appellees American Financial Group and its Consolidated Subsidiaries (collectively referred to as “American Financial”).

III. INTRODUCTION

This case addresses the interpretation of AG 33 for federal income tax purposes. Specifically, it is the position of the NAIC that AG 33 applies to all

¹ II NAIC *Accounting Practices and Procedures Manual* C-82 to C-88 (2010).

annuity contracts issued on or after January 1, 1981, because AG 33 is a clarification of existing law and did not constitute a change of method from any previously required method for valuing reserves. This position was originally addressed in a memorandum from NAIC Chief Legal Officer Andrew J. Beal dated August 31, 2006, which was submitted at the request of then-Ohio Director of Insurance Ann Womer Benjamin on behalf of American Financial. [RE 26-20 at 3].

Defendant-Appellant United States of America (hereinafter referred to as the “Government”) argues that the District Court erroneously construed § 807(d)(3)(B)(ii) of the Internal Revenue Code of 1986 (“IRC”), which requires a life insurance company’s reserves for annuity contracts to be determined using the Commissioners’ Annuities Reserve Valuation Method (commonly referred to as “CARVM”) prescribed by the NAIC “which is in effect on the date of the issuance of the contract.” 26 U.S.C. § 807 (1986). Specifically, the Government contends that the District Court gave undue deference to the NAIC’s interpretation of AG 33 as it relates to IRC § 807. “Although Congress adopted the NAIC’s reserve methods for annuities...it did not thereby delegate to the NAIC the authority to determine the parameters of CARVM’s application in federal tax computation...[T]he court erred in letting the NAIC play judge.” [Defendant’s Brief at 20].

It is not the intention of the NAIC to usurp the responsibilities and duties of this Court and “play judge” in this matter, nor does the NAIC claim to have the authority to exclusively determine the application of CARVM for federal tax purposes. Further, it is not the normal practice of the NAIC to become involved in tax disputes between state regulated insurance companies and the Government, except to the extent that it affects the financial solvency of an insurance company. However, as the drafter and issuer of NAIC actuarial guidelines, including AG 33, the NAIC is in a unique position to comment on these guidelines, including the interpretation and intent of AG 33, and the specific reasoning and history surrounding why it was adopted in its current form by the NAIC. In addition, by enacting IRC § 807, Congress has reserved a special role to the NAIC with respect to the interpretation of CARVM in federal tax matters.

By leading this Court through a discussion of the development and role of actuarial guidelines in general, and of AG 33 in particular, we hope to provide this Court with guidance as to why AG 33 does not have a “retroactive” effect, but rather is a clarification of existing law and does not constitute a change of method from any previously required NAIC method for valuing reserves. Therefore, the NAIC supports the decision of the District Court, and continues to endorse our original opinion that American Financial has correctly interpreted AG 33, and that

the Government has improperly characterized the effect of AG 33 as a change in method that is retroactive in nature.

IV. ARGUMENT

A. **NAIC actuarial guidelines are not intended to be viewed as statutory revisions, but are a guide to be used in applying a statute to a specific circumstance.**

CARVM was first defined by the NAIC in the 1976 amendments to the Standard Valuation Law, which prescribes minimum standards for the establishment of liabilities and reserves resulting from life insurance and annuity contracts. Standard Valuation Law, *VI NAIC Model Laws, Regulations and Guidelines*, 820-1 to 820-28 (1942, 2010).² The CARVM reserve is defined under § 5a.B of the Standard Valuation Law to be “the greatest of the respective excesses of the present values, at the date of valuation, of the future guaranteed benefits...provided for by the contracts... over the present value, at the date of valuation, of any future valuation considerations derived from future gross considerations.” *Id.* at 820-18.

Effective January 1, 1981, the NAIC amended the Standard Valuation Law to provide a formula to determine the interest rate to be used in computing minimum annuity reserves, which corresponds with the effective date of AG 33. 1

² Available on Westlaw.com at N.A.I.C. Model Laws, Regulations and Guidelines, NAIC 820-1.

Proc. of the Nat'l Ass'n of Ins. Comm'rs 765-773 (1981).³ The NAIC has not amended the definition of CARVM under the Standard Valuation Law since its adoption in 1976, and currently all 50 states and the District of Columbia have adopted the Standard Valuation Law and CARVM as their method for valuing annuity reserves. Standard Valuation Law-State Adoption Table, *VI NAIC Model Laws, Regulations and Guidelines*, 820-29 to 820-36 (2010).⁴

One of the primary functions of the NAIC is to adopt model laws, regulations and guidelines with respect to a wide variety of insurance products sold throughout the United States. Although the NAIC represents all state insurance commissioners, the NAIC itself lacks the direct authority to make state law, so that the model laws and regulations adopted by the NAIC have no legal standing until formally enacted by the various states. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-372, INSURANCE RECIPROCITY AND UNIFORMITY 9-10 (2009). However, while the model laws and regulations are developed with the intent of being both comprehensive and unambiguous, it is virtually impossible--given the continually evolving scope of life insurance products--for the NAIC to develop model language that addresses every issue regarding life and annuity

³ Available on *Lexis.com* at Proceedings of the National Association of Insurance Commissioners, 1981-4 NAIC Proc. 515 (Part 3).

⁴ Available on *Westlaw.com* at N.A.I.C. Model Laws, Regulations and Guidelines, NAIC 820-29.

reserves. See Mark Peavy, *NAIC's Actuarial Guidelines*, *The Financial Reporter* (March 1995).⁵

The development of actuarial guidelines by the NAIC began in 1977, when it was noted that the guidelines for claim reserves contained in the NAIC's *Financial Condition Examiners Handbook*⁶ (then the only guidance regarding life and annuity reserves other than the Standard Valuation Law) contained only a few pages with respect to claim reserves, and that considerably more elaboration was needed for actuaries, and that either a separate section of the Examiners Manual should be devoted to actuarial guidelines and procedures, or such guidelines and procedures should be inserted in the appropriate places in the manual. 2 Proc. of the Nat'l Ass'n of Ins. Comm'rs 445 (1977).⁷ The first 4 actuarial guidelines were adopted by the NAIC in 1978 for inclusion in the NAIC's *Financial Condition Examiners Handbook*. 2 Proc. of the Nat'l Ass'n of Ins. Comm'rs 448-453 (1978).⁸

⁵ Attached to this brief as Exhibit A.

⁶ "This handbook provides a 'guide' to assist state insurance departments in establishing and operating an effective examination system...It is expected that the concepts and principles of the examination approach described in this handbook will be used on all examinations, regardless of the type of company, company size, or other factors." I NAIC *Financial Condition Examiners Handbook* 1-1 (1996). The actuarial guidelines are to be used as a reference for the examiner in determining whether life and health insurance reserves were calculated correctly under the handbook. *Id.* at 9-1, *et seq.*

⁷ Available on *Lexis.com* at Proceedings of the National Association of Insurance Commissioners, 1977-2 NAIC Proc. 438.

⁸ Available on *Lexis.com* at Proceedings of the National Association of Insurance Commissioners, 1978-2 NAIC Proc. 379.

By 1980, the NAIC began working on a numbering system in the Examiners Handbook for the accumulated actuarial guidelines because of some confusion surrounding the process. 2 Proc. of the Nat'l Ass'n of Ins. Comm'rs 897 (1980).⁹ There was also need for the NAIC to clarify the intent and purpose of the actuarial guidelines. "Such actuarial guidelines are not to be construed as mandatory upon commissioners, but a commissioner may wish to apply them when he or she encounters situations where he or she feels that the underlying statutes are ambiguous or unclear." 1 Proc. of the Nat'l Ass'n of Ins. Comm'rs 556 (1980).¹⁰ In a Special Report to the Life Insurance Subcommittee dated October 23, 1980, a Preamble, Numbering System and Table of Contents were developed for the actuarial guidelines. 1 Proc. of the Nat'l Ass'n of Ins. Comm'rs 788-790 (1981).¹¹

The Preamble to the Actuarial Guidelines provided, as follows:

The NAIC (C4) Life, Accident and Health Insurance Technical Subcommittee has been asked on many occasions to **assist a particular state insurance department in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of original drafting of a particular statute.** The (C4) Technical Subcommittee, in developing its interpretation or guideline, must often consider the intent of the statute, the reasons for initially adopting the statute and the current situation. The (C4) Technical Subcommittee feels that for those situations which are sufficiently common to all states, that the

⁹ Available on Lexis.com at Proceedings of the National Association of Insurance Commissioners, 1980-2 NAIC Proc. 882.

¹⁰ Available on Lexis.com at Proceedings of the National Association of Insurance Commissioners, 1980-4 NAIC Proc. 515 (Part 1).

¹¹ Available on Lexis.com at Proceedings of the National Association of Insurance Commissioners, 1981-4 NAIC Proc. 515 (Part 3).

publishing of actuarial guidelines on these topics would be beneficial to the regulatory officials in each state and would promote uniformity in regulation which is beneficial to everyone. To this end, the (C4) Technical Subcommittee has developed certain actuarial guidelines and will continue to do so as the need arises. **The guidelines are not intended to be viewed as statutory revisions but merely a guide to be used in applying a statute to a specific circumstance.** [Emphasis Added].

Id. at 789-790.¹²

The Government argues that CARVM “should be read to encompass *all* of the NAIC’s guidance regarding CARVM, not just the general framework of CARVM contained in the Standard Valuation Law.” [Defendant’s Brief at 30]. However, the Preamble clearly differentiates between the roles of NAIC model laws and actuarial guidelines, assigning a hierarchy for their interpretation.¹³ Specifically, actuarial guidelines are not statutory revisions and are not binding on states to the same extent as a model law, but are a guide for interpreting a model

¹² This Preamble was later updated and amended in 2001 for inclusion in the NAIC’s *Accounting Practices and Procedures Manual*. 1 Proc. of the Nat’l Ass’n of Ins. Comm’rs 963 (2000).

¹³ Former NAIC Life & Health Actuary Mark Peavy provides further discussion summarizing the NAIC process for drafting model laws, regulations and actuarial guidelines in his article *NAIC’s Actuarial Guidelines*, *supra* note 5: “To assist the states in applying the provisions of the models in a reasonable and consistent manner, the NAIC Life and Health Actuarial (Technical) Task Force occasionally develops written actuarial guidelines on a particular aspect of life or health insurance valuation or nonforfeiture standards.... Possible actions are:

- (1) The topic is so fundamental to the regulatory process that it requires the creation or amending of a model act
- (2) The topic critically relates to enforcing a general standard imposed by a model act and therefore requires the creation or amending of a model regulation
- (3) The topic involves the interpretation of how an existing model act or regulation should apply in a particular case and therefore requires the issuance of an actuarial guideline
- (4) The topic is not of sufficient interest or urgency to warrant further action”

law. Actuarial guidelines clearly have a different function than do NAIC model laws and regulations, and this is particularly true with respect to the Standard Valuation Law and CARVM.

B. AG 33 is an interpretation of CARVM and does not constitute a change of method or basis from any previously used method, and does not constitute a retroactive change to CARVM.

The NAIC adopted AG 33 in 1995.¹⁴ The primary purpose of AG 33 is to provide consistency in the reserving of annuities that have multiple benefit streams. 4 Proc. of the Nat'l Ass'n of Ins. Comm'rs 1124-1126 (1994).¹⁵ The guideline provides for the basic interpretation of CARVM and applies to all individual annuities issued on or after January 1, 1981. *Id.* at 1125-1126. AG 33 provides in specific part:

Industry practices and methods of reserving under CARVM for individual annuity contracts with multiple benefit streams have not been found to be consistent....The purpose of this guideline is to codify¹⁶ the basic interpretation of CARVM and does not constitute a change of method or basis from any previously used method, by clarifying the assumptions and methodologies which will comply with the intent of the SVL....This

¹⁴ The NAIC later amended AG 33 effective December 31, 1998, but these changes did not affect the issues pertinent to this case. Keith P. Sharp, *CARVM and NAIC Actuarial Guidelines 33 & 34*, 7 Journal of Actuarial Practice 125, 126 (1999).

¹⁵ Available on *Lexis.com* at Proceedings of the National Association of Insurance Commissioners, 1994-4 NAIC Proc. 1091.

¹⁶ Actuarial guidelines can be formally adopted by the states, incorporated by reference in directives, bulletins, and administrative letters, or followed informally by the states. The term "codify" as used in AG 33 does not refer to incorporation into the Standard Valuation Law or CARVM, and should more accurately be described as being a guide used in applying a statute to a specific circumstance. 2 Proc. of the Nat'l Ass'n of Ins. Comm'rs 1106 (2000). Available on *Lexis.com* at Proceedings of the National Association of Insurance Commissioners, 2000-2 NAIC Proc. 1095.

guideline shall be effective on December 31, 1995, affecting all contracts issued on or after January 1, 1981. *Id.*

The clear intent of AG 33 can be found in the four-corners of the guideline itself: (1) there were inconsistent methods and practices in the insurance industry for reserving under CARVM for annuities with multiple benefit streams¹⁷; (2) AG 33 interprets CARVM by clarifying the assumptions and methodologies which will comply with the intent of the Standard Valuation Law; and (3) it does not constitute a change of method for CARVM or basis from any previously used method. However, the Government argues that this Court should in effect ignore the clear intent of the NAIC that AG 33 does not constitute a change to CARVM, and find that AG 33 constitutes a retroactive change to CARVM. [Defendant's Brief at 29].

AG 33 became effective with respect to all annuity contracts issued on or after January 1, 1981. 4 Proc. of the Nat'l Ass'n of Ins. Comm'rs 1126 (1994). As previously noted, while CARVM first became effective in 1976, the NAIC amended the Standard Valuation Law effective January 1, 1981, to provide a formula to determine the interest rate to be used in computing minimum annuity reserves. Section 6.A of the Standard Valuation Law is the minimum reserving

¹⁷ See Comments on Guideline GGG submitted by the American Academy of Actuaries dated August 17, 1993. "Various interpretations of CARVM have been made by insurance companies and regulators for this product...It is logical that a guideline be written so that a consistent interpretation of CARVM can be used." Attached as Exhibit B to this brief.

requirement, and provides “[i]n no event shall a company’s aggregate reserves...be less than the aggregate reserves calculated in accordance with the methods set forth in Sections 5, 5a [i.e., CARVM] and 9 and the mortality table or tables and rate or rates of interest used in calculating nonforfeiture benefits for the policies.” *Supra* at 820-19.

Therefore, the Standard Valuation Law itself makes a clear distinction between (1) the “method” set forth for calculating annuity reserves under Section 5.a (i.e., CARVM); and (2) the rates of interest used in calculating benefits under the contract (i.e., “assumptions” under NAIC Statement of Statutory Accounting Principles No. 51, “Life Contracts” at ¶ 15¹⁸). The effective date of AG 33 takes this distinction into account.

The Government’s argument that the effective date of AG 33 makes it retroactive in nature is not new to this proceeding, and was specifically considered by the NAIC Life and Health Actuarial Task Force.¹⁹ As early as 1992, insurance companies were commenting that AG 33 should not be given retroactive or retrospective effect because the companies relied in good faith on earlier regulatory

¹⁸ I NAIC *Accounting Practices and Procedures Manual* 51-1, 51-4 (2010).

¹⁹ The Mission of the Life and Health Actuarial Task Force is to identify, investigate and develop solutions to actuarial problems in the life and health insurance industry. It reports to both the NAIC’s Life Insurance and Annuities (A) Committee and Health Insurance and Managed Care (B) Committee. http://www.naic.org/committees_lhatf.htm.

interpretations.²⁰ However, when presented with this issue, the Task Force specifically took the position that the guideline was not being applied retroactively, because it “is not a change to a previously established or permitted method.”²¹

As previously noted, AG 33 became effective with respect to all annuity contracts issued on or after January 1, 1981. This date was not randomly chosen, but correlates with the amendment of the Standard Valuation Law to provide a formula to determine the interest rate to be used in computing minimum annuity reserves. The date that CARVM was originally enacted (1976) presumably was not chosen because no states had at that time adopted the assumptions necessary to calculate annuity reserves under AG 33. AG 33 merely interprets the application of CARVM to annuities with multiple benefit streams, and cannot be said to have a retroactive effect.

This should be contrasted with an actuarial guideline that originally did have retroactive effect, but was later revised shortly after its enactment by the NAIC. Actuarial Guideline VIII “The Valuation of Individual Single Premium Deferred Annuities”²² was originally adopted by the NAIC in 1980, and provided “that the method identified [i.e., CARVM] was the only proper method for calculating

²⁰ See Comments on Proposed NAIC Actuarial Guideline GGG submitted by John Alden Life Insurance Company dated November 11, 1992. Attached as Exhibit C to this brief.

²¹ See Summary of Comments Received on Proposed Actuarial Guideline GGG submitted by Frank Nino dated August 31, 1994. It is the practice of the NAIC to submit responses to comments received from interested parties on models being considered for adoption. Attached as Exhibit D to this brief.

²² II NAIC *Accounting Practices and Procedures Manual* C-21 (2010).

reserves...in such a state, if the commissioner did decide to use this actuarial guideline.” 1 Proc. of the Nat’l Ass’n of Ins. Comm’rs 557 (1980).²³

However, it was reconsidered and revised by the NAIC because some states had not yet adopted the 1976 amendments to the Standard Valuation Law at the time the actuarial guideline was issued. “There was some feeling that the reserve method defined in the actuarial guideline should not be applied retroactively, so as to require increased reserves in annuities that were already in force.” *Id.* at 557. Therefore, with respect to those states that had not adopted the 1976 amendments, the revised actuarial guideline does not now require insurance companies to use CARVM for determining reserves.

By contrast, AG 33 does not have retroactive effect, because all states have now adopted CARVM as the method for valuing annuity reserves. True retroactive effect would be applying an actuarial guideline in those states which had not yet adopted the current version of CARVM, but not with respect to AG 33 which merely clarifies the basic intent of CARVM. Therefore, AG 33 does not have retroactive effect, and does not constitute a change or modification of CARVM.

²³ Available on Lexis.com at Proceedings of the National Association of Insurance Commissioners, 1980-4 NAIC Proc. 515 (Part 1).

V. CONCLUSION

For the foregoing reasons, the decision of the District Court in favor of Plaintiffs-Appellees should be upheld.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that on March 3, 2011, the foregoing brief was electronically filed with the Clerk of the Court by using the ECF system. Counsel for the appellants and appellees are registered ECF users and will be served by the ECF system.

/s/ Philomena M. Dane

Philomena M. Dane

EXHIBIT A

NAIC's Actuarial Guidelines

by Mark Peavy

The model laws and regulations promulgated by the NAIC are developed with the intent of being both comprehensive and unambiguous in their application. Unfortunately, given the continually evolving and expanding scope of insurance products, it is impossible to develop model language that precisely addresses every benefit design and premium structure. To assist the states in applying the provisions of the models in a reasonable and consistent manner, the NAIC Life and Health Actuarial (Technical) Task Force occasionally develops written actuarial guidelines on a particular aspect of life or health insurance valuation or nonforfeiture standards. This article briefly describes the process by which these actuarial guidelines are developed and implemented.

Examiners Handbook and the Actuarial Guidelines

The actuarial guidelines are included in the NAIC's two-volume *Examiners Handbook*. Volume I is the *Financial Condition Examiners Handbook*, and Volume II is entitled the *Market Conduct Examiners Handbook*. The guidelines themselves are included as Appendix C of Volume I. As stated in Volume I, the purpose of the handbook is to provide a "guide" in assisting state insurance departments in their financial examinations. The majority of Volume I deals with the mechanical tasks and procedures that the examiner should follow in conducting the exam. In this respect, the actuarial guidelines are different from the rest of the handbook because they attempt to explain how the general policy expressed in a model act or regulation should be applied to a particular actuarial issue.

As of the end of 1994, Appendix C includes guidelines numbered from I to XXXII, although the number "IX" is used three times (that is, *Guideline IX*, *Guideline IXA*, and *Guideline IXB*) and *Guideline XII* was "withdrawn" in March 1993. Since the primary role of the guidelines is to assist the financial examiner, it is not too surprising that virtually all of them deal with interpreting the Standard Valuation Law. However, given the similarities between calculating reserves and nonforfeiture

amounts, many guidelines also relate to the standard nonforfeiture laws for life insurance and annuities. The titles of the guidelines (for example, *Guideline XXXII* is "Reserve for Immediate Payment of Claims") reflect their technical nature. While there is no officially mandated format for the guidelines, they generally contain at least two sections:

- (1) A "background" section that describes the issue being addressed
- (2) A "text" section that explicitly states the position of the Task Force relative to the issue.

Guidelines also may include explicit "effective dates," depending upon the impact the guideline may have on existing products and the difficulty of making necessary administrative changes.

The Adoption Process

The actuarial guidelines have been the exclusive responsibility of the NAIC Life and Health Actuarial (Technical) Task Force. While ideas for new guidelines may come from any source, they usually are initiated by the actuaries who sit on the Task Force and reflect issues that have been raised in their home states. If formal procedures are followed, the issue will initially be presented to the Task Force during the emerging issues portion of its agenda, although sometimes an issue will be more informally raised during discussions of a related issue. By whatever process, the matter will be discussed by the Task Force members, and a determination made regarding the appropriate disposition. Possible actions are:

- (1) The topic is so fundamental to the regulatory process that it requires the creation or amending of a model act
- (2) The topic critically relates to enforcing a general standard imposed by a model act and therefore requires the creation or amending of a model regulation
- (3) The topic involves the interpretation of how an existing model act or regulation should apply in a particular case and therefore

requires the issuance of an actuarial guideline

- (4) The topic is not of sufficient interest or urgency to warrant further action.

If any of the first three options apply, the Task Force will recommend to the appropriate parent committee that this project be added to the agenda of the Task Force. (This recommendation is not necessary if there is already a project on the Task Force's agenda that encompasses the proposed guideline.) Ultimately, authorization for the project will be forwarded to the NAIC's Executive Committee and Plenary Committee for approval.

The actual development of the guideline is usually a lengthy process. Development of specific language will normally be assigned to the member of the Task Force who presented the issue. Depending upon the complexity of the issue and the other demands on that particular actuary, it can take from one to several months for the development of an initial draft. The actuary leading the process may seek the advice of others (both regulators and nonregulators). When the actuary leading the process has an initial draft, it will be discussed at one of the quarterly open meetings of the Task Force and generally included in the Task Force's monthly mailings. If other Task Force members or interested parties (including company actuaries, consultants, and consumer representatives) have particular questions or concerns about the initial draft, they suggest or request changes. Any revised draft is subject to further comments. This initial phase of development can be an extremely lengthy (and sometimes confusing) process.

Once the Task Force as a whole is satisfied, it will vote to request permission of the relevant parent committee to formally "expose" the document for comment. Unless the proposed guideline is extraordinarily controversial, the request for exposure will be granted, and a copy of the proposed guideline will be included in the *Proceedings* of the NAIC for that meeting (as well as in the Task Force's monthly mailings).

continued on page 21, column 1

NAIC's Actuarial Guidelines continued from page 20

Subscriptions to the *Proceedings* of the NAIC and the Task Force's monthly mailings (as well as the actuarial guidelines) are available to the public through the NAIC's Publications Department (phone, 816-374-7259).

Suggestions from outside parties, as well as the ongoing input from members of the Task Force, may result in an ongoing process of revisions to the draft. This process may continue for a few months or a few years, depending upon the complexity and controversy surrounding the particular issue. However, at some point either the guideline will be abandoned by the Task Force, or the Task Force will be satisfied that the draft represents a reasonable effort and will vote for its adoption.

If the guideline is adopted by the Task Force, it is forwarded to the appropriate parent committee for that committee's consideration. While there are exceptions, the recent history of actuarial guidelines suggests that once a

guideline has been through the approval process of the Task Force, it has incorporated enough of the expressed concerns that it is relatively satisfactory to all interested parties. If the parent committee is satisfied with the guideline, it will be adopted and forwarded to the full NAIC membership at the subsequent quarterly meeting. Once adopted by the NAIC, the guideline is assigned the next available Roman numeral and added to Appendix C of the *Examiners Handbook*.

While there is no formal adoption of the actuarial guidelines at the state level, they are still an integral part of state regulation. In order for a state to be publicly acknowledged under the NAIC's Financial Regulation Standards and Accreditation Program, the NAIC Model Law on Examinations or substantially similar provisions must be incorporated into state law. That model requires that the state adhere to the directions set forth in the *Examiners*

Handbook. Thus, a state should give consideration to the interpretations contained in the actuarial guidelines when monitoring compliance with their statutes and regulations.

Conclusion

Because the trend towards increasingly varied and complex product designs will surely continue, it is likely that the number of actuarial guidelines will continue to grow. The input of the actuarial profession into the development of the guidelines can be a very useful component of the process. Actuaries should be encouraged to follow the work of the Task Force and to provide it with their expertise as early in the process as possible.

Mark Peavy, FSA, is Health/Life Actuary at the National Association of Insurance Commissioners in Kansas City, Missouri.

Letters to the Editor

"Mutual Company GAAP Conversion"

Dear Editor:

I credit Walter Rugland and Bradley Smith with outlining a novel and potentially much easier solution to the determination of DAC for products subject to the new SOP in their article, "Mutual Company GAAP Conversion," in the December 1994 *Financial Reporter*. This solution involves what is essentially a purchase GAAP methodology (PGAAP) for determining the DAC asset, that is, a prospective solution only. I do not believe a proxy to the SOP DAC asset that is determined by using the proposed methodology will be acceptable for audited GAAP financial statements. This belief is based on several reasons and is predicated on the belief that HGAAP will generally be the appropriate model for mutual company GAAP reporting, rather than PGAAP.

My first concern is related to the choice of discount rate or rates. The

DAC asset produced by a PGAAP-type calculation is very dependent on the choice of interest rates, and the choice of such discount rates is more an art than a science. Traditionally actuaries have been reluctant to choose one interest rate (or series of rates) for PGAAP and provide a value of in-force determined at three different interest rates. Note that if an 11 percent discount rate is used to compute DAC, the asset at the end of three years is 23 percent greater than the same number computed using a 15 percent discount rate (using the same assumptions as the original article). Note also that there is no assurance that a current risk rate of return is consistent with the pricing hurdle rate, as is assumed in the article. This divergence may be especially true for a product that was priced to yield a 15 percent return on equity (a common target in the 1980s) but may currently use a lower risk rate of return for PGAAP.

Second, a DAC asset determined according to SOP rules may be considerably lower than the present value of future EGMs discounted at a risk rate



of return, if the deferrable cost were low enough. If I reduce the deferrable costs to half of those shown in the original article and reduce future gross profits to produce the same amortization rate, I produce a DAC asset using the PGAAP approach approximately 10 to 20 percent in excess of the SOP DAC at the end of three years, depending on the choice of discount rates. Such an example is not unreasonable for certain low-acquisition-cost products, such as mass merchandised products.

Third, it is unlikely that the SEC would find the use of a risk rate of return appropriate for DAC amortization. The SOP specifies the use of an

continued on page 22, column 1

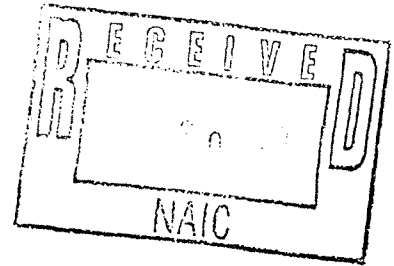
EXHIBIT B

Attachment 16

AMERICAN ACADEMY OF ACTUARIES

August 17, 1993

Mr. John Montgomery
Chairman
Life and Health Actuarial Task Force
California Department of Insurance
South Tower
300 South Spring Street
Los Angeles, California 90013



Re: Guideline GGG

Dear Mr. Montgomery:

The Academy of Actuaries Committee on Life Insurance reviewed the April 27, 1993 proposed Actuarial Guideline GGG. For the most part we agree with the interpretation of CARVM discussed in this guideline.

CARVM, when originally drafted, did not specifically address the two-tier product. Various interpretations of CARVM have been made by insurance companies and regulators for this product, which has resulted in varying reserve levels being established for similar products. It is logical that a guideline be written so that a consistent interpretation of CARVM can be used.

There is one area, however, where the current GGG proposal does not appear to be consistent with CARVM -- the requirement that, if current annuity rates are offered as an option, the ultimate reserves must be based on 95% of account values.

Basing the reserves on 95% of account values is arbitrary and not based on any actuarial demonstrations that we are aware of. In fact, Donna Claire's report showed that the first compromise of Guideline GGG produced reasonable reserves without the addition of the 95% factor. It appears as though your committee is imputing an artificial, arbitrary, and sometimes punitive level of reserves on products which you find objectionable. Wouldn't it be better to regulate the products rather than the reserves? Howard Kayton's group has produced a good start in limiting the disparity between the cash value and the value available for annuitization. Instead of setting artificially high reserves, we urge you to pursue the nonforfeiture law aspects.

If you would like us to do any further work on Actuarial Guideline GGG, please give me a call.

Sincerely,

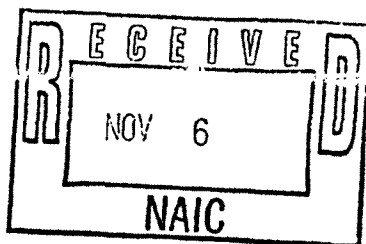
P. Andrew Ware
Chair, Academy of Actuaries
Committee on Life Insurance

cc: Jean Olson, NAIC

1720 I Street, NW - 7th Floor
Washington, DC 20006
Telephone 202-223-8196
Facsimile 202-872-1948

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EXHIBIT C



Attachment 11

November 11, 1992

Mr. John Montgomery
Chairman
NAIC Life and Health Actuarial
Taskforce
California Department of
Insurance
3450 Wilshire Boulevard
Los Angeles, CA 90025

Re: Comments on Proposed NAIC Actuarial Guideline GGG

Dear Mr. Montgomery:

We at John Alden were surprised by the appearance of proposed Guideline GGG. Given the extensive list of solvency issues on the NAIC's agenda, it seemed a curious use of the Taskforce's time to expedite a reserving fix in an area where extensive industry cash flow testing has indicated that nothing is broken. Nonetheless, the issue being raised, we offer our comments and would be pleased to participate in defining a solution.

Retrospectivity

The retrospective aspect of the proposed guideline seems inappropriate. It is our impression that where a guideline reverses prior regulatory interpretations upon which companies have relied in good faith--retroactivity would only be considered in the event of clearly-demonstrated reserve deficiencies.

While we can't speak for other companies, John Alden Life has in fact received substantial regulatory review--without negative comment--of its current dual interest annuity product reserving methods. Our current method employs differing valuation interest rates by policy benefit.

J. CALVIN WINTER, III, FSA, MAAA
Senior Vice President
Finance and Corporate Services

7300 Corporate Center Drive
Miami, Florida 33126-1208

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P.O. Box 020270
Miami, Florida 33102-0270

(305) 470-3265

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John Alden Life has a closed block (approximately \$400 million in reserves) of dual interest rate annuities written on two policy forms. Contracts were issued from 1986 through the beginning of 1991.

John Alden Life retained Tillinghast, a nationally recognized actuarial firm, to assist in the pricing and design of these forms. Among the terms of the Tillinghast engagement was a survey of then current reserving practices for the product. Included was a telephone survey of states where issue concentrations were contemplated. One state so surveyed was California. No negative comments on John Alden Life's proposed, and subsequently adopted, reserving methodology arose from this survey.

As a part of its policy form approval filing package, John Alden customarily provides a summary of its proposed product reserving methodology. Many states in fact require such information. Attached are summaries of state form filings for our two dual interest annuity product forms. Actuarial letters were included in these filings in every case. Please note that among those states approving the filings were: California, Colorado, Illinois and Texas. The most recent (1989) California form approval notes that the actuarial review was performed by John T. Gilchrist.

John Alden Life received its last NAIC Association Plan examination as of December 31, 1987 (The next will be as of December 31, 1992.) As of this last examination date a detailed actuarial examination was conducted of all of our policy and contract reserves. The report states "as a part of this review contracts for new products were reviewed...". Examination date reserves for dual interest rate products were \$41 million. Dual interest rate products constituted over 6.5% of all reserves for contracts written in the final year of the examination period. The examination report states that all reserves were approved "with no exceptions noted."

Hopefully this review of the facts will persuade you that John Alden Life received a considerable amount of feedback upon which it in good faith relied for adopting its current dual interest annuity product reserving methods. All pricing and credited rate decisions made to date have been predicated upon this reliance. Had John Alden Life received any negative feedback for its current dual interest annuity reserving methods from either its domiciliary state of Minnesota or the principal writing states for the product--appropriate and compensatory product design and contract form changes would most certainly have been made prior to product introduction!

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John Alden Life has prepared its own internal New York Regulation 126 type asset liability matching demonstrations as of each yearend since 1989. Our current annuity product reserves have satisfied every one of the seven scenarios in every one of these reports--in most cases for each and every individual scenario year!

John Alden Life was a cosponsor of the September 4, 1992 Milliman and Robertson "Actuarial Review of Draft Actuarial Guideline GGG" that was furnished to the Taskforce. Section V of the report examines a prototypical industry-wide dual interest annuity product and asset portfolio. For products valued on a "Type A" approach such as John Alden's, the Milliman and Robertson demonstration also shows reserve adequacy under every scenario for every benchmark year. Given the considerable surrender protection that this product enjoys relative to most other contemporary annuity products, Milliman and Robertson's findings are not at all that surprising.

Based upon the above, we at John Alden Life are hardpressed to spot any clearly-demonstrated reserve deficiencies as would customarily be required to retroactively change reserving methods used by companies in good faith reliance upon previously received regulatory guidance.

Theoretical Basis for Multiple Benefit Policy Reserving

In defining current dual interest product reserving methodology, John Alden, and most other companies, have pursued the following actuarial approach:

1. Choose the appropriate reserving for the primary product benefit in isolation; and
2. then make incremental reserving adjustments, as appropriate, for all secondary benefits.

This approach assures the necessary reserve sufficiency. And, it avoids reserving discontinuities--and hence unfair financial statement representations of relative financial strength--between companies with roughly similar--yet not wholly identical--products. The "single cloth" valuation approach in the proposed guideline violates this fundamental relative fairness concept.

The primary product benefit for a dual interest rate annuity product is of

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course the retirement income benefit. An annuity product having only this benefit (i.e. without a surrender value) would clearly be valued at a Type A rate.

The surrender value for a dual interest rate product is also clearly a secondary benefit. The function of the dual interest mechanism is, after all, to make the surrender benefit an appreciably lesser and less attractive amount. By itself, the greatest present value for the surrender benefit is determined using a Type C interest rate. The incremental addition to the basic reserve then becomes the excess, if any, of:

1. the surrender value greatest present value; over
2. the primary (accumulation) benefit greatest present value.

This results in a reserve both logically sufficient for the benefits provided--and also logically consistent with similar but not wholly identical products issued by the same or other companies.

Summary

John Alden Life, and likely many other companies, has in good faith relied upon a considerable amount of regulatory feedback in support of its current dual interest annuity reserving method. This method allows for different valuation interest rates, as appropriate, for various benefits within a single contract--as opposed to the single rate requirement of proposed Guideline GGG.

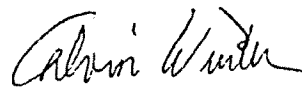
We are unaware of any clearly-demonstrated actuarial reserving deficiencies with our current, industry norm, reserving method. Given the good faith reliance of both John Alden Life and many of our peers on substantial prior regulatory feedback both in reserving our product and **in finalizing its current pricing and design**, we would assume that essential fairness would obligate the Taskforce to first demonstrate a reserving deficiency before promulgating a retroactive guideline.

We believe that our reserving method follows mainstream practice for valuing multiple benefit products. We also feel that it satisfies a fundamental actuarial principle which proposed guideline GGG clearly violates--that of logical consistency with reserves for roughly similar yet not wholly identical products.

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We do, nonetheless, appreciate that there may be legitimate reasons for the taskforce to further investigate and discuss the issues giving rise to draft Guideline GGG. And we would be pleased to lend whatever support that we may to this effort.

Sincerely,



J. Calvin Winter, III

cc: Ted Becker, Texas
Bob Callahan, New York
Greg Carney, Variable Annuity Life
Donna Claire, American Academy of Actuaries
Frank Dino, Colorado
Paul Facey, National Western Life Insurance
Larry Gorski, Illinois
Jean Olson, NAIC
Brad Barks, Life U.S.A.
Jim Pozzi, American National
Tony Spano, ACLI
Dennis Stanley, Milliman & Robertson

EXHIBIT D

AUG - 31 - 94 WED 2:51

Attachment 4

Date: August 31, 1994

To: Mark Peavy 816-287-4446

From: Frank Dino

Re: Proposed Actuarial Guideline GGG

Attached is a revised draft document of proposed guideline GGG which has been modified to address the comments received along with a summary of comments.

Please distribute this to the members of the Life & Health Actuarial Task Force.

AUG - 31 - 94 WED 9:51

P. 02

SUMMARY OF COMMENTS RECEIVED

1. Expand "other guarantees". Which tables apply if the guarantee is a death benefit, etc.

RESPONSE: Agree - this area has been expanded.

2. The rule should not be effective "retroactively".

RESPONSE: no change made. The rule is codifying the basic interpretation of CARVM and is not a change to a previously established or permitted method.

3. Annuitization assumptions should be permitted to use probabilities of election as determined by the company.

RESPONSE: disagree - no change made. CARVM does not permit probability of election. It is a worse case calculation.

4. 93% is an arbitrary reserve level.

RESPONSE: This level was determined after discussion and compromise. It is only applicable in the case where there are "contractual guarantees" to offer preferred purchase rates. Under CARVM, all guarantees must be valued. This is an estimate to reserve for a guarantee which is otherwise not being reserved.

5. Incidental benefits should be defined and exempted.

RESPONSE: disagree. CARVM requires ALL benefits to be reserved. If they are incidental, the impact of the calculation will be negligible.

6. Use of the SPIA valuation interest rates creates discontinuities.

RESPONSE: The use of which interest rate has been a continuing problem in the drafting of this guideline. It has in fact changed over time between three different options and approaches. None provided for unanimous industry support. The most compelling fact in arriving at the latest version is that it complies with what most participants believe the SVL to require.

7. the last sentence of the first paragraph of "purchase rates" could be improved.

RESPONSE: Suggested language has been incorporated.