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ACCOUNTING FOR INTERNAL REPLACEMENT PROGRAMS

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- o Applicable accounting rules
- o Replaced policies' unamortized acquisition costs
- o Capitalizing additional acquisition costs for new policies
- o Anti-selection on mortality experience of residual block
- o New policies' appropriate lapse, mortality and interest assumptions
- o Loss recognition testing
- o How does accounting treatment vary for the United States and Canada?

MR. HOWARD L. ROSEN: Universal life and other innovative interest-sensitive products have shaken the foundations of the insurance industry. These new products have raised a host of administrative, technical and practical questions:

- o What constitutes the revenue stream of new products?
- o Is there a computer system that can handle the administrative transactions that occur on a daily basis?
- o How are accruals developed on either a statutory or GAAP basis?
- o Is the investment department able to respond to the special needs of these products?
- o Should older business be intentionally replaced with some of these new products?

In company after company, the answer to this last question has been a resounding "Yes." But as companies developed new product programs, it became apparent that while there were silver linings, there were also clouds. As old products were replaced, very substantial GAAP losses sometimes occurred. This happened when the deferred acquisition cost released and the cash value paid out were in excess of the benefit reserves released.

Although many particular questions about interest-sensitive products remain unresolved, there is an existing body of knowledge which provides guidance on new product replacement programs. Internal replacement of policies by a new or different series is not a new phenomenon. It has happened for years, and in many cases has been

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planned from the time of the product's inception. A term conversion is an example of planned replacement, an original term policy is replaced by a second policy. Also, it is not unusual for individual health insurance writers to replace an older series policy with a newer one having different benefit structures and higher premiums. What was new in these programs was the level of loss that occurred, or could potentially occur, when organized replacement programs were carried out. Certain philosophical questions arose as actuaries and accountants began to handle the changeover:

- o Do the new policies constitute a new block of business or merely an extension of the original policies issued? After all, the policyholders are the same individuals!
- o Should the loss (or gain) resulting from the termination of the old policy be considered a cost of acquiring the new policy or just the cost of doing business?
- o If this gain or loss is to be considered an acquisition cost, how can it be capitalized?
- o Also, how can it be amortized after it is capitalized?
- o How is the old block of policies to be traced into the new one and kept track of over the years?

Much consideration has already been given to these and other questions. Work done by members of the Society of Actuaries (SOA), the American Academy of Actuaries (AAA) and the American Institute of Certified Public Accountants (AICPA) resulted in the inclusion of this topic in "Accounting By Stock Life Insurance Companies for Annuities, Universal Life Insurance and Related Products, and Accounting for Nonguaranteed -- Premium Contracts." This is an issues paper, now before the Financial Accounting Standards Board (FASB) and the basis of discussion in this session.

MR. KRISS CLONINGER III: As Mr. Rosen mentioned, a substantial volume of business is in the process of being restructured in most insurance companies. Large blocks of traditional business are being rolled over to interest-sensitive products. I'll refer to that family of products as universal life. I will discuss the FASB proposed accounting rules for the costs of internal replacement programs. It is noteworthy that while there is still some controversy over the accounting model that is to be applied, that is, the composite or deposit approach for universal life, there is no disagreement on the key points of accounting that I will discuss. In fact, no opposition arguments appear in the FASB issues paper. Thus, it seems reasonable to conclude that the guidelines for accounting for internal replacements are already generally accepted.

I'll discuss four general topics:

- o The costs of internal replacements
- o The reasons for deferring costs
- o Amortization of costs
- o Evaluation of cost recovery

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What are the costs?

Let me emphasize that we are talking about financial statement costs rather than current or future economic costs. In many cases, the economic costs of retaining business by replacing previous policies are less than those of acquiring new business. That is true because acquisition costs can be ignored in evaluating the economics of the situation.

However, for GAAP financial statement purposes, acquisition costs are a factor to be reckoned with. These still exist on the balance sheet in the deferred acquisition costs (DAC) column. If an internally replaced policy is treated as a lapse, its DAC would be charged to earnings at the date of lapse. That creates a financial statement loss. Other financial statement gains, or losses, that occur when a policy lapses are:

- o differences between the statutory policy reserve, the GAAP policy reserve, and the related cash value of the contract,
- o reserves on any supplemental benefits or riders that are attached to the base policy, and
- o differences between any net premium and gross premium accrual items.

The essence of one of the proposed rules is to quantify all the sources of gain or loss that would occur at the date of a lapse, then defer the net balance so that no gain or loss is recognized on the date the internal replacement transaction occurs. Under the wording of the issues paper, this approach would be followed whether the new balance is an asset or a liability. That is a technical observation as I have not yet seen a net liability in a universal life internal replacement program.

Another technical observation about the issues paper might be significant. The advisory conclusions state that the net costs:

should be considered to be the sum of the unamortized DAC related to the original contract and the difference between the cash value transferred to the new contract and the liability for the future policy benefits released from the original contract.

For that definition to work, that is, if no gain or loss is to be recognized, the term "cash value transferred to the new contract" has to include amounts such as policy loans on the original contract and any amounts not rolled over to the new contract.

Many internally replaced policies do have policy loans. It is common practice to extinguish the loan when the existing contract is surrendered, rather than carry the loan forward to the new contract. In addition, to comply with guideline premium limitations, some of the existing cash value may not be transferred to the new contract.

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Nevertheless, in order to compare apples to apples in determining the net cost of the internal replacement transaction, the gross cash value on the old contract is used to arrive at the correct answer.

Many companies have taken the position that the net cash value transferred to the new contract should not be reported as premium or surrender expense. This line of thinking is consistent with the view that there has only been a restructuring of the terms and conditions of the original contract rather than a lapse and a new issue. In addition to the conceptual justification for this approach, most companies do not believe it is appropriate to incur premium tax on these amounts.

Why should these costs be deferred?

The principal argument advanced in support of deferral is the restructuring concept just mentioned. This concept is not totally new. It was first applied to guaranteed renewable health insurance policies when existing contracts were exchanged for new ones with higher benefits and premiums. The original deferred acquisition cost was maintained, additional costs associated with the restructuring were capitalized and policy reserves were prospectively recalculated using the reserve on the old contract as the initial reserve. It was that experience that prompted me to write a paper for the "Transactions" suggesting that the prospective recalculation of reserves and amortization of deferred costs might be appropriate when premiums were changed on indeterminate premium products.

I also saw the restructuring concept applied in accounting for single premium deferred annuity (SPDA) contracts that were rolled over to contracts providing high initial interest rates. The practice of not reporting rollover amounts as premium and surrender expense was typical in the SPDA environment.

There are other arguments in support of deferring net costs of internal replacement transactions. Many companies have considered those as acquisition costs in the pricing of their universal life product. There are *variable commissions on universal life issues that involve internal replacements*. Reduced commissions are paid in those situations where there is not a significant increase in premium or coverage amounts. If the old net cost was not carried forward in that circumstance, the company would report a current loss and realize higher profits in the future. This is because they would have written off the old DAC at the date of internal replacement, and would not have to incur a subsequent amortization expense. That situation would appear to violate the provision of FASB 60 that says that losses should not be presently recognized if it results in an apparent future profit.

A final argument in support of deferral is that these costs vary with, and are primarily related to, the acquisition of new and renewal insurance contracts. That, of course, is the primary criteria for determining that a cost is eligible for deferral.

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How should the costs be amortized?

For those of you who like multiple-choice questions, I have prepared some possible answers:

- (A) Against the future revenues of internal replacement contracts
- (B) Against the future revenues of all universal life contracts, including internal replacements
- (C) Very slowly
- (D) (A) or (B)
- (E) All of the above.

I think the correct answer is (D), either against the future revenues of internal replacement contracts or against the revenues generated from the aggregate block of universal life contracts. An aggregate approach should appropriately reflect the different expectations as to persistency, lapse and so on for the internal replacement versus the regular new issues.

The expectations as to persistency, mortality and future premiums are likely to differ between new and replacement issues. Assumed investment yields are also likely to vary given that assets are segmented for new and replacement contracts. Each factor affects the amortization rate in different ways. The companies I work with have tended to aggregate deferred costs for both internal replacements and new business and work with composite assumptions, aggregate assumptions if you will, for combined new and internal replacement business. I suspect that practice has been adopted with an eye to systems considerations since it's cumbersome to keep track of the two blocks in the valuation process. But the aggregate approach is permissible under the rules. The advisory conclusions stipulate that:

those costs should be amortized over the term of the replacement contract in the same manner as additional deferred acquisition costs incurred.

How should recovery be evaluated?

FASB 60 provides that only costs that are recoverable from future revenues should be deferred. Recoverability tests are generally performed for groups of similar contracts. The issues paper suggests that there are three possible groupings of business from which the costs of internal replacement might be recovered:

- o Replacement universal life contracts issued in the period
- o All universal life contracts issued in the period
- o All ordinary life insurance contracts issued in the period

Some believe that recoverability testing should be performed separately for internal replacements and regular new issues. Their reasoning is that the contracts or the characteristics of the internal replacement block are sufficiently different to warrant separate treatment in evaluating recoverability costs. Others feel that the expected persistency, mortality and investment yields might be different for the

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internal replacement block. But the fact that all universal life business is written on the same plan of insurance is, in fact, adequate justification for performing recoverability tests in the aggregate for the universal life block. Those of us who hold a macro view of the world contend that universal life contracts are simply one more block of ordinary life business and that recoverability tests should be performed for the ordinary life line in the aggregate.

The draft advisory conclusions indicate that the highest level of grouping that will be deemed appropriate is all universal life issues for the period. Those who drafted the conclusions felt that universal life contracts are sufficiently different from ordinary contracts to warrant separate treatment. The conclusions specifically state that consideration be given to the special characteristics of internal replacement contracts in establishing the assumptions used in determining whether or not a premium deficiency exists.

It is important to note that a premium deficiency is deemed to exist only if there are no future profits left in the block of business. Thus, even though future profits may be lower than those targeted for a new issue, acquisition costs should not be written off simply to maintain acceptable future profit margins.

MR. PAUL F. KOLKMAN: Now that we've had an overview of the relevant issues-paper accounting rules for internal replacements, I would like to take a more detailed look at several technical issues. Specifically, I'll be concentrating on the accounting at that moment in the replacement process when the old, obsolete product is exchanged for the new, dynamic product.

First, we'll look at the cost of discontinuing the old policy, calculated at the moment of replacement. Second, we'll look at the capitalizable replacement cost on the new policy. That is, how much of the cost of discontinuing the old policy can be carried over and capitalized on the new policy. Then, we'll combine these results to look at the net impact of the replacement on the financial statement. Finally, we'll cover a few points about additional acquisition costs that can be capitalized on the new replacement policy. Throughout the discussion, we will be talking about internal (as opposed to external) replacements and will refer to financial statement costs, not economic ones.

Our first and easiest step is to define the financial statement cost of discontinuing the old policy. This cost has an immediate impact on GAAP earnings and is the same whether we are talking about internal replacement, external replacement or lapse. In any of these cases,

(Financial Statement Cost) = (the old policy's benefit reserve)
-- (the old policy's unamortized deferred acquisition cost
(UDAC)) -- (the old policy's cash value (CV))

That is,

$$\text{Cost} = V_t - \text{UDAC}_t - \text{CV}_t$$

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Under this definition of cost, a negative result implies a loss to the company and a positive result implies a gain.

As a simple example, consider policies A and B, which have somewhat different financial balances at the time of replacement.

	<u>Policy A</u>	<u>Policy B</u>
Reserve	\$100	\$100
CV	80	50
UDAC	50	30
	Cost = 100 - 50 - 80	Cost = 100 - 30 - 50
	Cost = (30)	Cost = 20

Given our cost formula, the reserves, CVs and UDACs, it is easy to determine that policy A causes a loss of \$30 and policy B causes a gain of \$20 at the moment of replacement. The numerical results that occur in practice are not always so simple and straightforward as indicated in the next example -- a disability income plan.

Disability Income Plan

<u>Duration</u>	<u>Benefit Reserve</u>	<u>Expense Asset</u>	<u>Sales Compensation Asset</u>	<u>Cost = Gain (Loss)</u>
1	121.95	(227.96)	(204.22)	(310.22)
2	244.35	(208.46)	(207.33)	(171.43)
3	366.75	(191.27)	(212.32)	(36.85)
4	488.92	(176.20)	(219.23)	93.50
5	610.65	(162.42)	(227.81)	220.42
6	731.40	(149.14)	(209.19)	373.07
7	850.50	(136.96)	(192.10)	521.44
8	966.97	(125.80)	(176.44)	664.74
9	1,079.77	(115.57)	(162.09)	802.11
10	1,188.23	(106.21)	(148.96)	933.06
11	1,291.35	(96.75)	(135.70)	1,058.90
12	1,387.95	(88.04)	(123.48)	1,176.43
13	1,476.75	(80.01)	(112.22)	1,284.51
14	1,557.22	(72.62)	(101.85)	1,382.75
15	1,628.85	(65.81)	(92.30)	1,470.74

During the first fifteen durations, the benefit reserve increases while the unamortized general expense and sales compensation assets

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decrease. The gain or loss on discontinuance represents a situation in which, under GAAP, the financial statement may show a profit for the company but is not representative of true economic costs. A lapse results in smaller realized profits than those that would result from the policies remaining in force. The primary reason for gains from this product is that there are no cash values payable upon lapse.

Another nonuniversal life product that illustrates the cost of replacement is a SPDA.

Single Premium Deferred Annuity

<u>Duration</u>	<u>Reserve = Accumulated Value</u>	<u>Expense Asset</u>	<u>Sales Compensation Asset</u>	<u>Surrender Value</u>	<u>Cost = Gain (Loss)</u>
1	16,080.00	(288.73)	(721.84)	14,954.40	115.03
2	17,038.77	(271.93)	(679.82)	16,112.92	(25.90)
3	17,841.75	(249.32)	(623.29)	17,034.86	(65.71)
4	18,359.30	(220.63)	(551.58)	17,696.30	(109.20)
5	18,659.97	(188.41)	(471.02)	18,155.25	(154.70)
6	18,936.54	(155.11)	(387.77)	18,595.13	(201.46)
7	19,185.44	(120.78)	(301.94)	19,012.52	(249.80)
8	19,401.80	(85.47)	(213.68)	19,401.80	(299.16)
9	19,578.80	(45.37)	(113.43)	19,578.80	(158.80)
10	19,709.99	.00	.00	19,709.99	.00

A small gain for the company occurs in the first year after issue, if the policy should be replaced at that time. After that, losses increase up to the eighth year after which the replacement cost rapidly falls to zero, due to the amortization that is employed. My company, Northwestern National, did have a significant amount of SPDA replacements several years ago, so we in management know that replacement activity is not limited to universal life.

However, since universal life replacements of traditional business are of greatest interest today, the next two tables illustrate the costs of replacing two traditional whole life products. The first table illustrates a low-cash-value plan, with benefit reserves and cash values increasing by duration and deferred acquisition costs amortized slowly over time. Following the third duration, the cost of replacement increases by duration.

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Whole Life - Minimum Cash Value

<u>Duration</u>	<u>Benefit Reserve</u>	<u>Cash Value</u>	<u>Expense Asset</u>	<u>Sales Compensation Asset</u>	<u>Cost = Gain (Loss)</u>
1	596.63	.00	(826.70)	(817.30)	(1,047.37)
2	1,105.20	.00	(776.72)	(776.30)	(447.83)
3	1,588.72	91.22	(734.47)	(742.78)	20.25
4	2,039.19	779.20	(694.18)	(711.47)	(145.66)
5	2,458.30	1,419.63	(655.76)	(682.32)	(299.41)
6	2,847.81	2,013.25	(619.13)	(655.28)	(439.85)
7	3,208.89	2,561.54	(584.18)	(630.32)	(567.15)
8	3,542.75	3,066.53	(550.85)	(607.40)	(682.04)
9	3,850.09	3,529.75	(519.05)	(586.49)	(785.20)
10	4,131.71	3,952.74	(488.71)	(567.58)	(877.32)
11	4,387.55	4,336.60	(459.76)	(533.95)	(942.76)
12	4,617.73	4,682.12	(432.13)	(501.86)	(998.38)
13	4,820.00	4,989.91	(405.76)	(471.24)	(1,046.89)
14	4,994.11	5,260.54	(380.60)	(442.02)	(1,089.05)
15	5,141.88	5,495.07	(365.60)	(414.15)	(1,123.94)

The second table illustrates the effect of replacement of a high-cash-value plan. Surprisingly, during the first fifteen durations, the loss from replacement is relatively constant.

Whole Life - High Cash Value

<u>Duration</u>	<u>Benefit Reserve</u>	<u>Cash Value</u>	<u>Expense Asset</u>	<u>Sales Compensation Asset</u>	<u>Cost = Gain (Loss)</u>
1	553.51	737.78	(826.70)	(965.90)	(1,976.87)
2	1,020.93	1,355.56	(776.72)	(917.45)	(2,028.80)
3	1,500.36	1,970.33	(734.47)	(877.83)	(2,082.27)
4	1,947.27	2,542.54	(694.18)	(840.83)	(2,130.28)
5	2,363.36	3,073.09	(655.76)	(806.38)	(2,171.87)
6	2,750.34	3,562.48	(619.13)	(774.43)	(2,205.69)
7	3,109.39	4,011.92	(584.18)	(744.93)	(2,231.64)
8	3,441.68	4,423.21	(550.85)	(717.84)	(2,250.23)
9	3,747.90	4,797.62	(519.05)	(693.13)	(2,261.89)
10	4,028.83	5,136.45	(488.71)	(670.77)	(2,267.10)
11	4,284.40	5,440.57	(459.76)	(631.03)	(2,246.95)
12	4,514.71	5,710.57	(432.13)	(593.11)	(2,221.09)
13	4,717.50	5,946.80	(405.76)	(556.91)	(2,191.98)
14	4,892.47	6,149.67	(380.60)	(522.38)	(2,160.18)
15	5,041.45	6,320.08	(356.60)	(489.45)	(2,124.68)

A summary of these results is given in the next table. From this we get some idea of the variability in replacement costs. Either a gain or

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a loss may occur when a disability income or SPDA policy is replaced. But when a traditional whole life policy is replaced by a universal life product we would typically get a loss.

Summary of "Costs"
Gain (Loss)

Duration	Disability Income	SPDA	Whole Life	
			Min. CV	High CV
1	(310.22)	115.03	(1,047.37)	(1,976.87)
2	(171.43)	(25.90)	(447.83)	(2,028.80)
3	(36.85)	(65.71)	20.25	(2,082.27)
4	93.50	(109.20)	(145.66)	(2,130.28)
5	220.42	(154.70)	(299.41)	(2,171.87)
6	373.07	(201.46)	(439.85)	(2,205.69)
7	521.44	(249.80)	(567.15)	(2,231.64)
8	664.74	(299.16)	(682.04)	(2,250.23)
9	802.11	(158.80)	(785.20)	(2,261.89)
10	933.06	.00	(877.32)	(2,267.10)
11	1,058.90	.00	(942.76)	(2,246.95)
12	1,175.43	.00	(998.38)	(2,221.09)
13	1,284.51	.00	(1,046.89)	(2,191.98)
14	1,382.75	.00	(1,089.05)	(2,160.18)
15	1,470.74	.00	(1,123.94)	(2,124.68)

The cost, as reflected in these examples, is heavily influenced by the following variables:

- o Type of policy (disability income, annuity, whole life)
- o Type of plan (high CV, low CV, whole life)
- o Duration of the replacement
- o Level of deferred acquisition costs at issue; method and period of amortization of these costs

Now let's turn our attention to how much of this cost may be carried over and capitalized on the new policy.

According to the November 5, 1984 FASB issues paper:

the costs of internal replacement should be considered to be the sum of unamortized deferred acquisition costs related to the original contract and the difference between the cash value transferred to the new contract and the liability for future policy benefits released from the original contract.

The key term in this definition is "cash value transferred." The definition implies that if the cash value rolled over to the new policy is not equal to the cash value released from the old policy, an adjustment of some sort is necessary. Taking the issues paper literally would lead to the following formula:

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$$\text{Cost} = V_t - \text{UDAC}_t - (\text{CV}_t - D_t) \quad (1)$$

where D_t is the cash not rolled over to the new contract at the time of replacement.

The other significant piece of literature on this subject is the September 13, 1984 discussion memorandum on Accounting for universal life prepared by the Academy's Committee on Financial Reporting Principles. This paper defines capitalizable cost two ways. The first is the same as that used in the FASB issues paper. The second definition is similar but leaves out any reference to cash values transferred. Therefore, it is the same as our definition of the cost of the old policy at the moment of replacement:

$$\text{Cost} = V_t - \text{UDAC}_t - \text{CV}_t \quad (2)$$

A third possible definition, not in the literature, would be one that makes a proportional adjustment for any cash value transferred:

$$\text{Cost} = \frac{\text{CV}_t - D_t}{\text{CV}_t} V_t - \text{UDAC}_t - \text{CV}_t \quad (3)$$

While not in the literature, this formula may be in the spirit of the FASB paper, which seems to imply the need for some adjustment based on cash value transferred. Whatever the cost of discontinuing the old policy, that portion which is rolled over will be carried over to the new policy.

Now let's return to policy A in our original example. Assume a \$20 cash withdrawal.

Reserve old policy	=	\$100
CV old policy	=	80
DAC old policy	=	50
Cash withdrawal	=	20 (therefore CV transferred = 60)

Using our capitalizable cost formulas we get the following results:

<u>Formula</u>	<u>Capitalizable Cost</u>
(1) FASB Definition	(10)
(2) AAA Definition	(30)
(3) Proportional Definition	(22.5)

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If we net the capitalizable cost of the new policy and the cost of discontinuance of the old policy, we get the impact on the company's financial statement. In this example, that can vary from (20) to 0. This amount of variability was never intended by the authors of the Academy and FASB papers.

	<u>Old Policy Cost</u>	<u>Capitalizable Cost</u>	<u>Net</u>
(1)	(30)	(10)	(20)
(2)	(30)	(30)	0
(3)	(30)	(22.5)	(7.5)

Where does this leave us? The FASB paper says (and the Academy paper implies) that internal replacement of traditional policies with universal life should not result in the recognition of a profit or loss at the moment of replacement unless there is a question of recoverability of the deferred asset.

This general statement can be taken as the essence of replacement accounting theory. It argues for setting the capitalized cost equal to the immediate gain or loss incurred on the termination of the old policy, ignoring the cash value transferred adjustment. This position appears to be permissible provided that the total capitalizable cost is recoverable in the future. If, on the other hand, an adjustment for the cash value transferred is to be included, a proportional adjustment will usually produce a more theoretically reasonable result.

I should mention that I have made one significant assumption in my remarks so far. That is, I have assumed that the company has the capabilities of obtaining all the information necessary to evaluate the cost of replacements. For example, the company's service area is able to identify internal replacements and code them as such. Having flagged the replacements, the company has the computer capabilities to calculate the appropriate financial information. If this is not true and replacement information is unavailable, special accounting practices may be difficult to justify as well as impractical to implement. I have a feeling that not everyone is able to pinpoint all this data accurately. I would be very interested in hearing, during our question and answer period, what companies are doing.

The final topic I would like to cover is the additional acquisition costs for replacement policies. These costs may have a different mix than those for new business. For instance, most companies do not reunderwrite internal replacement policies if they are for the same face amount as the original policy. This eliminates a significant front-end cost. Also, many companies do not pay full first-year commissions on replacement business. The additional margins resulting from these practices can be used to amortize the unrecovered costs of the old policy.

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While not exactly an accounting issue, I think the subject of replacement commissions is perhaps the most crucial decision made by companies involved with internal replacement. If a company's rules are perceived as too conservative by its agents they may, depending upon their loyalty, take their business elsewhere. On the other hand, if a company's commission replacement rules are too liberal, it runs the risk of having its entire in-force business rolled over.

The following rules are important when setting internal replacement commissions rules:

- o Encourage replacements only if they are beneficial to the policyholder.
- o Encourage increases in both premium and face amount.
- o Preserve the financial solvency and profitability of the company.
- o Adequately compensate the agent for his service to the existing policyholder.
- o Make sure the rules are simple to understand and to administer.

I suspect that some of these rules are easier to state than to practice. Actual practice with replacement compensation varies considerably. This is highlighted in a recent Life Insurance Marketing and Research Association (LIMRA) study of over one hundred companies:

Internal Replacement Commission Practices

	<u>Percent of Companies</u>
Full first-year commissions paid	16
Full first-year commission only on increase of new policy over old	32
Percentage of full first-year commission according to ratio of new policy to old	28
Percentage of full first-year commissions according to policy year of old policy	11
Other methods	13

This study assumed that a universal life policy is replacing a permanent policy and that the entire unloaned CV is rolled over.

Obviously, the most liberal practice is that of paying full first-year commissions. Some of the companies doing this are relatively new, and therefore have little in-force business to lose. The most common replacement commission practice is also the most stringent -- 32 percent of companies pay full commission only on the increase of the new policy over the old. The other methods generally fall between these two extremes.

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MR. DANIEL J. KUNESH: So far we have learned about the general framework of accounting rules applicable to an internal replacement program, and about its deferrable costs. Next, I will talk about experience assumptions in an internal replacement program, and how these assumptions might enter into the reporting process.

It is expected that future experience on replacement business may differ from newly issued business. Obvious causes for this difference include:

- o varying contract features,
- o certain economic realities that surround an internal replacement program, and
- o improved customer and agency attitude toward the company.

Regarding contract features, we have already heard what companies have done to reduce commissions payable on internal replacement business. Many companies will also reduce or eliminate policy loads on cash value transferred to the replacement policy (so-called lump sum premium). Because reunderwriting is most often only required for certain increases in the amount of insurance coverage, the cost of underwriting an internal replacement policy should be less than for a new issue.

Other contract features which may have a smaller impact on claims experience are the incontestable and suicide clauses in life insurance contracts and the pre-existing conditions clause found in health contracts. Normally, they apply only to increased coverage amounts.

Assumptions such as persistency, mortality and future premiums are likely to differ for replacement business because they relate to continuing policyholders rather than to new policyholders. Likewise, investment yield assumptions may differ because an internal replacement program generally will not substantially increase the amount of new cash available for investment at current market rates. Instead, existing invested assets are normally carried over to the replacement policy in support of the transferred cash value; thus current book value for these assets may vary substantially from their current market values because of lower yield rates. Yet, most companies will credit the same rate of interest to transferred cash values as to new money. More will be said about interest assumptions later.

Other economic realities of an internal replacement program include reduced underwriting and an increased level of premiums. Consider a universal life replacement program as an example. Most companies will follow their existing standards for medical and nonmedical underwriting on internal replacement products. Because, normally, only policies with increased amounts of coverage are subject to reunderwriting, most will avoid the more thorough investigation afforded new applicants. Therefore, experience mortality on the replacement policy might be expected to fall somewhere between that for a new issue risk and that for an ultimate risk.

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To date, companies have been encouraged by the increased level of premium from the replacement policies. Experience to date has shown that increases average somewhere between 30 and 40 percent. This is largely due to encouragement by the agent to improve coverage amounts. It also reflects various incentive compensation techniques employed by companies embarking upon an internal replacement program.

Most industry experts believe that internal replacement policy persistency will be better than that of a new issue in the early years. One recent study has shown that customers who ultimately replace internally express a high degree of satisfaction with the company, its replacement product, and/or the assisting agent. According to the study, internal replacers were actually more satisfied with their overall insurance coverage than maintainers. This is attributed to their willingness to be approached by the agent for the expressed purpose of discussing replacement.

It is this satisfaction, combined with favorable agent and company communications, that leads many to believe that internal replacers will have good future persistency. In fact, they believe replacement universal life lapse rates from date of replacement will resemble ultimate lapse rates on universal life new issues -- flat and low.

However, it is important to exactly define a universal life lapse. As with flexible premium annuities, we have to consider both contract persistency patterns and premium suspension rates. To date, contract persistency on universal life has been excellent, exceeding 90 percent in the first year for most companies. Contract persistency of internal replacer policies is even better -- averaging nearly 95 percent thus far with companies that have the ability to measure such persistency. Quite possibly, the fact that contractual surrender penalties start over again, as under a new issue, discourages early surrender.

Premium suspension rates, however, have not been as encouraging. This is especially true in the early renewal years when, rather unexpectedly, little improvement from first-year rates have been noticed. Of course, the product is no more than two to three years old, so there are only one or two years of renewal experience.

Again, as with contract persistency, premium persistency has been more favorable for replacement policies than for new issues, but worse than actual contract persistency patterns. While it is too early to come to any conclusions, many consider this pattern disturbing. They claim the very favorable contract persistency patterns to date could deteriorate rapidly as recently-issued universal life policies are replaced by other new products, possibly variable universal life.

Let's take a closer look at anticipated interest and mortality experience under an internal replacement program. As stated earlier, it is unlikely that an insurer is going to credit a lower rate of interest to transferred cash value. Yet, it is quite likely that assets supporting

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these transferred funds are yielding a return which is less than new money rates, and possibly even less than the current credited rate. This may be especially true at old line stock and mutual companies where internal replacement programs are targeted at traditional cash value products sold several years ago.

Another aggravation arises from the fact that as interest rates in the financial markets have dropped in the last year or two, life insurance companies have been slow in reducing their credited rate, for competitive and other reasons. This has resulted in a reduction of the actual spread between the earned and credited rates. Current average new money rates are still somewhere between 12 and 12.75 percent. However, credited rates still remain in the 11 to 11.50 percent range, and some are still going up to 12.25 percent. Thus, the spreads have been reduced from two hundred or more basis points to a range between seventy-five and one hundred and fifty. Unfortunately the greatest impact is felt by lump sum money, largely derived from cash value transfers in the internal replacement program. In such cases, the actual spread may be negative.

Likewise, mortality patterns can be different. First look at the anticipated experience on the residual block of business. No doubt experience will vary dependent upon the level of external and internal replacement activity. Replacers are policyholders who are still insurable. In effect, the industry is identifying present insurable policyholders and recruiting them as select risks. Therefore, if insurable lives are consistently weeded out of the population of aggregate or partially selected lives and then reentered as select lives, the impact on the mortality experience of the residual policyholders can be very unfavorable indeed. Such experience will vary greatly between companies, dependent upon the level of underwriting done on the original policies and the average policy age at replacement. Since little experience data are available so far, no definitive trends can be cited.

Experience on replacement business will depend largely on the amount of reunderwriting performed. Most companies will at least ask the standard set of medical questions on the application. This should weed out many would-be internal replacers who have become uninsurable. However, dependent upon a company's nonmedical limits and its success in encouraging premium and amount increases, the level of reunderwriting beyond a simple review of the health questions on the application will vary widely and, in many instances, may be largely nonexistent.

Two other reunderwriting concepts are noteworthy. First, most policies being replaced did not differentiate nonsmokers from smokers. Through a question on the application, this risk classification is now being recognized. Many believe this fact will bring nonsmoker replacement applicants closer to true select lives.

Second, what impact will reinsurance have on expected mortality patterns? Consider a program intended to replace graded premium whole life products, issued on a reentry basis, with a regular universal life product. Quite likely, the graded premium product will have

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coinsurance; yet many of the universal life products today involve simple yearly renewable term reinsurance. In the question and answer session, I would be interested in hearing comments about how companies are reacting to reinsurance and how the reinsurers are reacting to internal replacement programs, especially replacement programs involving term insurance. Unfortunately, it is still too early to determine what, if any, impact these various patterns will have on experience mortality. At best, one can guess that replacement policy mortality experience will be less select than on a new issue, and the grading to aggregate rates will take place over a shorter period of time.

To what extent do companies reflect these experience patterns when reporting on internal replacements? As we have heard, accounting practices vary widely among companies. To a large extent, a company's efforts are reflective of the success of its internal replacement program relative to its new sales in total. Many companies do little more than recognize differences in the amount of deferred acquisition costs under the replacement program. Other companies have a problem identifying which policies are new issues and which are internal replacements due to system constraints. These companies find it difficult to define the cost of the replacement program. They hope to embody anticipated experience in the internal replacement business by establishing a composite set of assumptions representing both new issues and internal replacements.

Some companies, with substantial programs, have the ability to segregate new issues from replacements and to identify the cost. However, normally these companies will establish sets of factors for reserves and deferred acquisition costs unique to their replacement business. Assumptions underlying these factors are defined using criteria much along the lines of my earlier discussion. For such companies, the amount and types of cost deferred in the program will normally be defined as discussed by Mr. Kolkman. Interest assumptions seldom vary from that used for new issues, even though the reality of the situation is that earned rates underlying cash value transfers are often less than the credited rates. Persistency assumptions, comprising a blend of premium and contract persistency patterns, will normally be more favorable than for new issues with a more rapid grading to level ultimate rates. Mortality assumptions will normally reflect a modified select and ultimate basis whereby the assumption in the year of replacement may compare with the third or fourth policy year of a new issue, thus grading to ultimate rates in a shorter period of time.

In summary, a general caution might be raised for companies. Auditors will question accounting practices of any internal replacement program deemed to have a material impact on the company's operations. Auditors give the following assumptions special attention:

- o The cost of the program
- o The real spread between earned and credited interest rates (especially where there is a significant number of rollovers)
- o Persistency, mortality and morbidity in replacement versus new issue business

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Indeed, a company must not fail to recognize reasonable margins for adverse deviations in setting assumptions. As we have heard, tests of recoverability of deferred costs become an important phase of internal replacement accounting. Given the increased competitiveness of universal life products today and the cost of an internal replacement program, auditors will be especially concerned about the results of these loss recognition tests.

Before we go into the question and answer session, I want to make just a few comments on Canadian practice. Replacement experience in Canada has not been nearly as profound as that in the United States. It seems that voluntary product enhancements have been more popular. A company will use an amendatory rider to modernize the benefit structure for a given class of policyholders. A number of companies, however, have initiated internal replacement programs in an effort to conserve their business.

Canada does not currently have a GAAP system of reporting comparable to that in the United States. While the issue has been under intensive study for some time, no definitive guidelines are really expected for the next year or two. Even then, it is expected that solvency concerns will take precedence over the income statement. Further, it is believed that the valuation actuary will retain a major responsibility in financial reporting with expressed reliance on his work by independent auditors.

In Canada, solvency concerns are addressed at the national government level, not in the individual provinces. Surplus appropriations, as necessary, are made below the line as in the United States. Thus there is no impact on earnings of special surplus appropriations.

Two aspects of Canadian reporting are significant. First, net unitary reserves are established whereby a substantial portion of a company's actual acquisition costs are recognized. These costs, which are limited to 150 percent of first-year premiums, are deferred and offset against benefit reserves rather than expressed explicitly as an asset. Second, reserve assumptions are not bound by a lock-in concept as found in the United States. Instead, changes can be made annually at the valuation actuary's discretion. In reality, few changes have occurred and they normally have represented only minor revisions to key valuation assumptions.

To date, no special adjustments have been made to reserves when accounting for internal replacements in Canada. Quite possibly, this is because most of the programs to date have not had a material impact on operations. Thus, reserves are fully released on the old policy and the replacement policy is treated as a new issue. Any transferred cash value of course would enter the reserve calculation.

While, in theory, cost deferral should be limited to the actual cost of replacement, Canadian actuaries have stated that full deferrals still take place. They believe that the unamortized portion of deferred acquisition costs netted against reserves on the old policy, when added to the additional costs of issuing the replacement policy, would probably approach or exceed the 150 percent limitation. In any event, no

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conscious effort has been made to embody the actual cost of replacement, as previously defined, into the reserve calculations.

MR. ROSEN: The FASB paper concludes that the cost of replacement should be capitalized by and amortized against all universal life insurance issues of the replacement period. Does that imply that, after the year of replacement, other lines of business in the ordinary area or other years of issues cannot subsidize continued losses resulting from the replacement activity?

MR. CLONINGER: Yes. The advisory conclusions indicate that loss recognition testing should be done using the highest level split of in-force business -- all universal life contracts issued for the period. This test would apply to the initial year to determine the cost that can be recovered. Subsequent tests for loss recognition would have to be made against the aggregate block of universal life issues, probably not issue-year specific subsequent to the first year. But it would seem that the intent of the advisory conclusions is to require consideration of all universal life issues as a line of business for the purpose of testing recoverability.

MR. ROSEN: What problems might companies -- using worksheet capitalization and amortization rather than factors -- encounter if they want to take advantage of the no-loss/gain concept of replacements?

MR. KUNESH: I would assume that the companies using a worksheet approach may have difficulty separating internal replacements from new issues. That is a problem right off the bat. But assuming the ability to identify the cost of the program, there should be no impact on it. If cost can be defined, a gain or a loss can be avoided.

Subsequent amortization using a worksheet is subject to the same criticism such approaches have had in the past -- to what extent can the amortization pattern be related to the actual evolving experience of that block of business?

I think few companies are set up right now to properly monitor this experience. Some companies may not have even quantified the cost. Some companies do amortize the cost of replacement policies using a worksheet method. But additional compensation is amortized using a factor method. Reserves for internally replaced policies might use similar or the same assumptions as those used for new issues.

MR. ROSEN: How does one identify the deferred acquisition costs from replaced policies which were established in aggregate, and amortized by a worksheet method.

MR. CLONINGER: Clearly that's a problem because all the issues were aggregated in the past. Worksheets typically operate with one amount of unamortized cost for all issues in a particular calendar year. The best I've been able to do in dealing with that practical problem is to first look at the unamortized balance of deferred costs per thousand of face amount as a percent of premium in force by each year's business written. Then I attempt to identify, by issue year, the volume of

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business and premium that has been internally replaced. This is in order to obtain a reasonable estimate of the unamortized cost associated with the internal replacement contracts. That's about the only way to do it, unless history can be recreated. That is generally not possible, and why worksheets are utilized in the first place. But, perhaps other people have been able to handle those kinds of issues in different ways.

MR. ROSEN: By a show of hands, could we get an idea of how many companies represented here have a formal internal replacement program? About 25 percent.

MR. GRANT HEMPHILL: Would your comments about not recognizing a gain or loss from a replacement policy apply to the present value of future profits on a purchased block of business?

MR. CLONINGER: You mean where purchase accounting has been applied in the past in an acquisition, and now you are faced with restructuring the contracts you have acquired by purchase of another company. I'll speak for myself and let the other panelists comment also. It's pretty clear to me that the asset value of business acquired is essentially the same as the value of deferred acquisition cost. It ought to be treated in the same manner as deferred costs that arise from contracts originally written as opposed to those obtained through purchase. I don't see that any distinctions would be appropriate.

One interesting thing that comes up with purchase business, that has not been dealt with in the issues paper and hasn't been addressed so far in this panel discussion, is the issue of deferred tax. In a purchase transaction, the booking of the valued business acquired generally has an effect on the value of the deferred tax carried on the balance sheet. It's something that ought to be considered.

MR. ROSEN: I also think that one of the key points is the definition of cost. If we are talking about a financial statement cost, it is clear that once a company has gone through purchase accounting, the present value of profits gets onto the balance sheet. To the extent that the present value of profits can be identified back to a policy, there would be financial statement loss just as if a deferred acquisition cost asset or true expenditure asset is released. I think that there might very well be a strong analogy between the present value of profit assets and the deferred acquisition cost assets.

MR. STEVEN MAHAN: What would be the proper handling of a situation where the replacement policy has a front-end load?

MR. ROSEN: Where there is a deferred acquisition cost asset and a load, it is accepted procedure to defer only those expenses in excess of the load. If the loss on the replaced policy constitutes a cost of acquisition, then similar logic should apply; to the extent that the transferred loss exceeds the load on the new contract, there would be a capitalization and an amortization.

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MR. CLONINGER: Even if the composite approach were applied?

MR. KOLKMAN: There are two separate issues here. The first is what cost from an internal replacement transaction is carried forward. The second is how the new issue is accounted for once the new business is written.

We haven't discussed the so-called composite methodology that's been put forth to account for universal life contracts. And we haven't discussed the deposit approach. But you asked, specifically, what the appropriate accounting is once the new product has been issued. That is a different question than what should be done with the implicit cost of internal replacements. It may be a fine line of distinction, but if the deposit methodology is applied, that first year load would be netted against the deferrable cost associated with a new contract, which would include the cost of the internal replacement transaction. If the composite methodology is applied, there will be a different answer because then the benefit reserves are involved. In trying to make additional provisions for adverse deviations, it might be advisable to avoid netting. No significant amount of profit would emerge in proportion to the premium collected under the new contract.

MR. KUNESH: The Academy and FASB papers, in dealing with accounting for SPDAs, raise the possibility of a similar situation. Part of your concern is that you have a load that exceeds new expenses. Should you let any of that fall through as profit? Rolling over a cash value from an old policy is akin to a single premium transaction. Most of the accounting literature says that when you have a single premium transaction, you have zero profit at issue. If you have costs in excess of your load, you defer them. If you have load in excess of cost, you set it up as a liability and run it off. That's not something that everyone agrees with, but that's the current guidance.

MR. CLONINGER: There is a special section in that position paper about lump sum deposits, and I think they would apply to a new issue or a replacement.

MR. STEVEN HODGES: You've addressed appropriate mortality assumptions for the replaced policies. Because some replacements are underwritten again, they are deemed to have better mortality expectations. Could someone address, in more detail, what considerations or techniques come into play with the residual block of policies?

MR. KUNESH: I touched on that very briefly in my presentation. Several items must be considered. The first is the type of product being replaced. For example, replacing a select re-entry term product by universal life would have one type of impact, especially if reinsurance is involved. The second item is reunderwriting rules in the internal replacement program. How rigorous are they? Are they merely an accommodation to attract the policy from its old format to the new? Indications are that there are fairly substantial increases in the amount of new coverage under the replaced policy. Yet, I think in many situations, this increase will not exceed the amount necessary to

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require medical examination. The questionnaire that is used for replacement policies generally has only a few questions. The underwriting of a replacement policy is not as extensive as the underwriting of a new issue. The intent of the questionnaire is to uncover the undesirable risks such as smokers. If the smoker cannot satisfactorily answer the smoker question, he will remain in the residual block. Increased margins for adverse deviation should be considered if the residual block is substantial.

MR. HODGES: How would you take that into account? The residual block is going to be worse. Do you run into a problem with the lock-in principle, if you try to set up something that would try to quantify that future loss? How would you amortize it?

MR. KUNESH: You can view recoverability from the standpoint of your total universal life block of business. You realize that your residual block is a loss. But would you still fake the experience of the entire block of universal life policies? Quite likely, that's what you would do.

MR. CLONINGER: The question, if I might rephrase it, is that if significant volumes of internal replacement transactions have occurred and the residual block of traditional ordinary life business is expected to have deteriorating mortality experience, what do you do relative to the lock-in principle and relative to loss recognition testing? I would say that you would continue to apply the lock-in principle to the extent that a loss recognition situation has not been created. That's consistent with GAAP guidelines. Clearly, in performing loss recognition tests on the residual block, you would have to consider that perhaps mortality will demonstrate unfavorable deviations in the future.

If you are able to stand those deviations and not have a situation where a premium deficiency exists, reduced profits will be reflected in the future. Now you might need to guard against the situation where there is an aggregate profit remaining in the block. You might expect profits, in the early years following the internal replacement program, to deteriorate into losses. It would be appropriate to expect profits over the first ten years and losses thereafter. That would, perhaps, unlock your assumptions in order to level the remaining profit margin in that traditional block.

MR. ROSEN: I generally agree, although I have seen situations where clients have been able to identify a particular line of business which has become a loser. They determined that they wanted to unlock their assumptions, because that block was a loser. If a company does that, and if it is found to be in keeping with acceptable accounting standards, they may find themselves locked into a situation where, on a continuing basis, they must keep track of most, if not all, of their major lines of business separately. If later on, another line of business develops the same sort of problem, they may be forced by their previous activity to also adjust for the problem on that block of business. In other words, if you do it once, you may be locked into it on other lines of business. Otherwise, you could be playing with your earnings, so to speak.