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FINANCIAL REPORTING TOPICS —CURRENT INTEREST

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MR. RICHARD K. KISCHUK: Our first presentation will be by Horace McCubbin who will cover recent financial reporting developments in Canada. Next, Bill Schreiner will discuss recent trends in the United States. Then John Montgomery will look into the future and share with us what is happening in the United States with regard to the NAIC statement blank and the possible future role of the valuation actuary.

MR. HORACE W. MCCUBBIN: Before addressing financial reporting developments in Canada it is desirable to give this audience a brief description of the Canadian environment as it impacts on financial reporting. Most Canadian life insurance companies are federally regulated and governed by the Canadian and British Insurance Companies Act. The Act was amended in a major way in 1978. The highlight of the 1978 legislation was that a single statement would be used for reporting, i.e. the same statement would be used for statutory reporting to the regulatory authorities and in published statements to the public. This reporting applies for both stock and mutual companies, and it will be recognized as significantly different from the reporting in the United States where two statements are common, one for statutory reporting and one for GAAP reporting.

The legislation requires the appointment by the Board of a Valuation Actuary who is charged with the responsibility for setting the reserve bases and ensuring a proper charge to income. In fulfilling this responsibility, the actuary is required to employ appropriate assumptions and provide actuarial reserves which equal or exceed a minimum legislated reserve which uses the actuary's assumptions but a specified modified net premium approach. This degree of responsibility which is legislatively delegated to the Valuation Actuary is another significant difference between the Canadian and U.S. environments.

The Valuation Actuary is supported in fulfilling his professional accountabilities by the Canadian Institute of Actuaries' Committee on Financial Reporting which has promulgated actuarial standards of practice for life insurance company reporting. These standards are referred to as the CIA Recommendations.

Turning now to an overview of the financial reporting developments in Canada, the first thing to note is that there has been no legislative or regulatory revisions of consequence since the 1978 revisions of the Act. It is anticipated, however, that there will be actions on the legislative front in the near future as a number of studies have been completed and recommendations will be made to the authorities for some changes. The primary studies have been joint efforts of the CIA and the CICA - the

Canadian Institute of Chartered Accountants - which is the professional body for accountants in Canada.

A landmark report on life insurance company financial reporting was published in December of 1982 by a Joint Task Force of the CIA and the CICA. The CIA's Committee on Financial Reporting has completed its analysis of this report and is reporting to Council this fall.
A second Joint Task Force of the two professional bodies reported in February of this year on the roles of the auditor and actuary in respect to financial statements. This report has been accepted in principle by both the CIA and the CICA.

The Council of CIA will be asked shortly to approve revisions to the CIA Recommendations in respect of financial reporting for Group Life and Health business of life insurance companies.

Prompted by recommendations in the Joint Task Force on life company reporting, the industry association in Canada, CLHIA, is making representations to the government to modify the method of reporting for stock and real estate investments.

The financial reporting focus in Canada in the last few years has been the work of the Joint Task Force of the CIA and CICA on life insurance Company financial reporting. Assessments of its final report are all but completed and action by regulators and professional bodies can be expected in the near future.

The Task Force was to develop and recommend financial reporting and disclosure principles which would become generally accepted actuarial principles and generally accepted accounting principles, and which would permit both solvency reporting and income reporting in a single set of financial statements. The principles were to cover life and accident and sickness business - both participating and non-participating - written by mutual and stock insurance companies. The recommendations of the task Force were wide ranging and there has been general agreement with them in the actuarial and industry bodies.

Major recommendations on which there is agreement are as follows:

1. Statutory accounting for portfolio investments recognizes the spreading of <u>realized</u> gains and losses on all portfolio investments and of <u>unrealized</u> gains and losses on stock investments. For fixed income securities, a straight line amortization is employed, while for stocks a 7% moving average method is used. Recommendations are made for a discounting method of amortization on fixed income securities and the removal of an arbitrary 20 year amortization period; for a more rapid amortization rate on stocks; and for the application of the amortization principle for gains and losses on real estate. All of these modifications would require changes in legislation.

2. At the present time, the legislation imposes a maximum of 150% of the net level annual premium on the amount of recoverable acquisition expenses that can be deferred and amortized, and that amortization commences in the second policy year. It is recommended that there be no maximum, i.e., that all recoverable acquisition expenses be deferred, and that the amortization commence in the first policy year.

Again, the legislation will need to be revised.

3. Currently the law requires an appropriate assumption be made for each contingency which materially affects the company's net income, but does not allow the Valuation Actuary to use a cash value floor option rather than a proper valuation of the withdrawal risk. The Task Force recommends that the surrender privilege be properly accounted for when determining actuarial liabilities so that the treatment will be consistent with the general theory of release from risk, and the principle of matching revenues and related costs will be satisfied.

4. In Canadian financial reporting there is a wide diversity in the method of recognizing taxes and there is no legislative prescription. The recommendation is that the accrual method with discounting for interest and an assumption as to future tax rates, be employed in the calculation of deferred taxes.

5. The Task Force recognizes that there can be restrictions on the distribution of surplus and recommends that all the restrictions be disclosed by a way of note to the financial statements, that such a disclosure include a brief description and the amount of each component and that mandatory and voluntary restrictions be distinguished.

6. The majority of life company financial statements at the present time account for foreign currencies at book rates of exchange. A major departure from this procedure is recommended in that it is proposed that all assets and liabilities would be transmitted at current rates of exchange on the balance sheet date and that all revenues, expenses, gains and losses would be translated at average exchange rates for the accounting period.

There are two particular areas covered by the Task Force recommendations on which there is <u>not</u> general agreement. These areas are of significant concern to actuaries as they deal with actuarial liabilities and changes in actuarial liabilities.

The recommendation of the Task Force is that actuarial liabilities be calculated so that there is a provision for adverse deviations which appropriately tests solvency. Extensive discussions on this recommendation have been conducted by the CIA's Committee on Financial Reporting and it is expected that the Committee will conclude that a provision for adverse deviations must be included in the actuarial liability, but that a provision that is appropriate for financial reporting purposes cannot also serve as a suitable test of solvency. It is contended that the introduction and release of valuation margins should not unduly distort the measurement of earnings, so that the considerably greater degree of conservatism required for testing solvency would fail that test. The suggestion is that a proper level for adverse deviations be included in the actuarial liability for financial reporting purposes, and that the additional margin required for solvency be an appropriation of surplus. This process would be an extension of the already mandated surplus appropriations for negative reserves and cash value deficiencies. The CIA's Committee recognizes the need for relevant work to define processes which can quantify the appropriate tests of solvency and is cognizant of the considerable amount of work that has already been done by the Society of Actuaries on the C-1, C-2 and C-3 risks.

A further recommendation of the Task Force is that in the income statement assumed future cost be matched to assumed future premium revenue through the facility of the actuarial liabilities. The CIA's deliberations on this aspect of financial reporting have drawn considerable support for the view that this matching is achieved appropriately and directly by recognizing in the valuation all future benefits and expenses, and the full amount of future policy premiums. Acceptance of the use of the full policy premium in calculating actuarial liabilities would be a significant departure from the present practice and the Task Force basis of using net premium valuations.

In accordance with generally accepted accounting principles it is recommended that the effect of changes in valuation assumptions be reflected in income rather than treated as an extraordinary item, a prior period adjustment or a direct surplus transaction. The Task Force envisages the change being spread over the current and future years, but it is expected that the CIA position will propose that the change be born entirely in the current year.

The timing of the adoption of the proposals made by the Task Force is uncertain. It is hoped however, that the CIA and the CICA will be able to specify that those recommendations on which there is agreement will now be considered as generally accepted accounting principles for life company financial reporting, and that revisions would be made in these principals as the more contentious issues and legislative amendments are resolved. Another major accomplishment during 1984 has been the approval in principle by the CIA and CICA of the proposals of a Joint Task Force on the roles of the auditor and actuary in respect of financial statements. The primary proposals are as follows:

1. It is recommended that a proposed Joint Policy Statement that describes the procedures a "reporting professional" should follow in using the work of a "specialist professional" be made part of the CIA's Recommendations and the CICA Handbook. A "reporting professional" means the actuary or the auditor who is using the work of the other, and a "specialist professional" means the actuary or the auditor whose work is being used by the other.
2. It is recommended that the Valuation Actuary of a Canadian insurance company be required to report in person at least annually to the Board of Directors and that he be elected annually by the shareholders and policyholders. Legislation would have to be changed to implement this recommendation as, at present, the Valuation Actuary need only be appointed by the Board and no formal reporting process is mandated.

The Joint Policy statement has application only when one professional is using the work of the other, who is a specialist in a field in which the first professional is not formally trained. For example, an auditor may not be competent to make a detailed assessment of the actuary's work. The Statement is lengthy and covers the following points:

(a) Describes the criteria by which the reporting professional may assure himself that he has a basis for using the work of a specialist professional.
(b) Presents the criteria by which the specialist professional's

qualifications, competence, integrity, and objectivity can be judged. For example, an actuary's Fellowship in good standing in the Canadian Institute of Actuaries is taken as prima facie evidence of his professional qualification.

(c) Identifies the content that should be contained in the report from the specialist professional that is given to the reporting professional.

(d) Recommends the type of communications that should take place between the two professionals to establish the needs and working relationship between the two.

(e) Requires the disclosure of the respective roles to the readers of financial statements because of the dual reporting requirements of such statements. It is recommended that the disclosure be provided by Management as part of its report accompanying the financial statements or, alternatively, by a note to the financial statements.

(f) Makes provision for using the work of another auditor or actuary where, in the rare case, the reporting professional cannot conclude that he should use the work of the specialist professional. In such cases the appointed specialist professional must be independent of either of the original participants and management.

The Task Force report of February, 1984 which includes the Joint Policy Statement has been circulated to the members of both the CIA and the CICA. It is anticipated that the Joint Policy Statement will be made part of the standards of each of the professional bodies in 1985.

The third significant development in Canada is in respect of the reporting of stock and real estate investments. Building on the work of the Joint Task Force and the efforts of the CIA Financial Reporting Committee, the CLHIA is recommending to the Department of Insurance in Ottawa that,

> effective for 1984, realized and unrealized gains and losses on stock in the life branch be amortized at 15% per annum (vs. 7% currently) on a declining balance method and that this change be prospective only involving no reinstatement of prior period results and no adjustment to surplus.

A committee proposal that realized and unrealized gains and losses on real estate in the life branch be amortized on a declining balance method on a prospective basis, as proposed for stocks, is receiving further study. Currently, realized gains are recognized as a full and immediate "below the line" income item.

In accordance with its mandate to maintain up-to-date standards of practice the CIA's Committee on Financial Reporting will shortly be recommending to the CIA Council revisions in the Recommendations and Explanatory Notes for the financial reporting of Group Life and Health business. The revisions are intended to recognize the special features of this type of business; for example, the use of experience rating refunds and excess interest credits payable to non-participating policyholders, the significance of the elimination period and the definition of disability for disability insurance, the need to include claims adjustment expenses in administrative expense, and recognition of the yearly renewable term method of providing group insurance.

MR. WILLIAM SCHREINER: I will report on current events in financial reporting on the U.S. side of the border, with respect to both GAAP and statutory reporting. I will start with GAAP, but before going into recent activities, it will be helpful if I outline the GAAP accounting standard-setting hierarchy in the United States.

In the U.S., the court of first resort is the American Institute of Certified Public Accountants (AICPA). For life insurance companies issues, the AICPA works through its Insurance Companies Committee. This committee is charged with handling the wide range of issues that relate to life insurance companies and their products. The Committee accomplishes its work through various task forces that are assigned to specific topics. The Insurance Companies Committee reports to AcSEC, the highest accounting standard-setting body in the AICPA. AcSEC is the Accounting Standards Executive Committee. When the AICPA is done with an issue, AcSEC typically passes it on to the Financial Accounting Standards Board, the FASB, which either asks the AICPA to go forward with the proposed accounting advice on their own, or takes the subject onto its agenda for further consideration. FASB is the body charged with setting GAAP accounting standards in the United States.

But, of course, there remains the SEC, which could be termed the court of last resort, because the SEC has been charged by Congress with the supervision of publicly traded companies including, of course, insurance companies. Fundamentally, the FASB sets GAAP standards at the sufferance of the SEC. The SEC has the legal authority to set financial reporting standards independent of what the FASB says is GAAP. Let me now move to the specific issues that have recently received attention.

The key GAAP issue of this year has been accounting for annuities and universal life insurance. And the key issue in accounting for annuities and universal life insurance has been, "to what extent should insurance companies' profit be recorded as premiums are received?" The current accounting model originated in the Audit Guide of 1972 and was carried forward in the FASB Statement of Financial Accounting Standards No. 60, which sets the accounting standards for life insurance enterprises. Under the current accounting model, a significant portion of the anticipated profits of a life insurance or annuity product will be recorded as premiums are received. When this model was initiated in 1972, the typical life insurance product was a whole life or term policy and that model is generally credited with having worked very well for such products. However, many new products, such as universal life and single premium deferred annuities, have been marketed in recent years. The spark that generated this recent interest in the accounting standard was the single premium deferred annuity product. If you have an accounting model that lets you record profits when premiums are received, that means that you get an awful lot of profit on the first day of a single premium policy. That gave the SEC considerable concern. Further, this concern was magnified by the fact that the SPDA product was the predominant source of sales for Baldwin-United and some other troubled companies. Hence, the SEC has been urging the accounting community to do something about the accounting model for life insurance companies as it applies to SPDA's and has shown a similar concern about accounting for universal life insurance.

In 1983, the AICPA Task Force that was working on the SPDA issue put out what they called a "preliminary draft" for SPDA accounting which banned the use of premiums as an element of profit recognition, thereby prohibiting the release of any profits when the policy was sold. Instead, profits would emerge over the course of the policy's existence as various risks were released and the policy continued. This conclusion was a major change in the accounting model. It obviously would markedly affect the reported earnings of any company that had a large amount of single premium deposit annuity business. But more importantly, it would represent a major change in the conceptual basis of the existing accounting model.

This past year the AICPA has attempted to pull this preliminary conclusion on SPDA's together with its consideration of the issue of how to account for universal life insurance. FASB No. 60 specifically says that the accounting model described there for life insurance products does not apply to universal life insurance. So, there clearly was a need to identify the appropriate accounting model for universal life insurance.

There have been three approaches, three accounting models, proposed and considered by the AICPA during its study period:

(1) First, the traditional approach, which permits profit to emerge as a level percentage of premium, after provision is made for adverse deviation.

(2) Another major approach that was considered was the "deposit" approach. The primary feature of the deposit approach is that no element of profit is allowed to emerge with premium receipt. Earnings, instead, are characterized as emerging "as realized". There are, in fact, two versions of the deposit approach. One, a retrospective fund accumulation approach, and another, a more actuarially-oriented prospective approach. But the key feature of that deposit approach is that no profits are recorded with the receipt of premium.

(3) The third accounting model that has been considered by the AICPA, has been termed the "composite" approach, and as you can tell from its name, it is a middle of the road approach. It does permit profits to arise as a percentage of premium, but the description of this approach emphasizes provisions for margins that go beyond margins for adverse deviation. Some believe that this composite approach can, for given circumstances, stretch from the traditional end of the spectrum where the earnings emphasis is on premium, all the way to the deposit end of the spectrum where no premium recognition is allowed.

The industry had considerable concern about the potential for the adoption of the deposit approach, particularly, with respect to universal life insurance. As this product was becoming more and more important to life insurance companies, were a brand new accounting model to be adopted for universal life, all other things being equal, a discontinuity of reported earnings would develop. Going from the traditional approach to the deposit approach pushes earnings recognition further out into the future. And this would presumably result in a different pattern of reported earnings of life insurance companies.

There was also concern that, if the deposit approach was adopted for universal life, inconsistent accounting principles for similar pucts would result. For example, considering universal life and whole life, it might be a matter of taste as to which product was sold in a particular situation. Thus, either product might be sold to the same people for the same reasons by the same sales force and, yet, depending on which product was sold, the accounting recognition of earnings would be quite different. However, the industry recognized that the existing traditional model presented problems with respect to the recognition of profits on single-premium or limited premium plans and, perhaps with respect to lump sum deposits on universal life plans.

The members of the ACLI's Committee on Financial Reporting Principles developed a proposal that they believed would solve the major problems of the existing model, without causing considerable disruption to the reported earnings of insurance companies that would result from the adoption of the deposit approach. The proposal was that the maximum premium which could be utilized in profit recognition would be the premium that would provide the plan's benefits in 20 level annual premium payments regardless of what the actual characteristics of the premium payments were. This clearly would go a long way toward solving the problem of single-premium products. It also would solve any potential problems for lump sum receipts on universal life. Also, its adoption would preserve the existing accounting model and a significant potential problem in the reported earnings of life insurance companies would be avoided.

To summarize an extended process of discussions with the AICPA: at the September 24 meeting of AcSEC, the Committee voted 13-0 to adopt, with the 20 pay limitation, the composite approach, which is conceptually consistent with the existing accounting framework. It has different words around it and different emphasis, but it is conceptually consistent. Furthermore, as I indicated before, for those companies or accountants who believe that the deposit approach might be the appropriate accounting vehicle for their particular situation, it can indeed stretch if not to the deposit approach, right next door to it by appropriate allocations of margins.

Also, at that AcSEC meeting, AcSEC voted that annuities should be accounted for by the deposit approach. The vote there was 9-4, and the majority feeling was, I think, that annuities were more of an investment product and, therefore, should be accounted for as an investment product. The minority view on AcSEC was that some annuities had very strong emphasis on life contingencies and should be accounted for as other life products are, that there were advantages to having a single accounting model for life insurance company products and that, in some circumstances, it was quite difficult to tell a life insurance product from an annuity product. What will happen now, if all goes according to standard procedure, is that the AICPA will send an issues paper to the FASB along with a commentary on their conclusions as to what is appropriate accounting for these life insurance products and then the FASB will take the issue onto its agenda and go through their usual sunshine procedures to consider what changes should be made in GAAP accounting for life insurance company products. The reason the FASB has to take it onto their agenda, is that this proposal would require a change to the current FASB-published accounting standards for life insurance companies.

Another issue that the AICPA worked on that was related to universal life was the issue of what do you do with respect to deferred acquisition costs on internal replacement plans. The question is whether you have to test the recoverability of existing and newly incurred acquisition costs solely against the new replacement policy, or is there some broader basis by which recovery should be measured? The accountants concluded that it could be measured against the current issues of the insurer, and that it would not be strictly limited replacement policies. This was not a controversial issue.

Let me now turn to other GAAP issues that have been dealt with in the past year. The first is deferred taxes. The new life insurance law of 1984 raises the issue of what to do with the deferred tax liabilities that have been established for reserve allowances that are now forgiven under the "fresh start" provision; for example, the 818(C) reserves. This was a FASB issue. In their first run at it, they concluded that these deferred tax liabilities should be released into 1984 earnings by restating the first quarter of 1984. In the final technical bulletin, they retained their conclusion that the release of deferred tax liabilities should be taken into 1984 earnings, but they decided that they could be taken into earnings in the third quarter, or in the fourth quarter if one did not yet know what the amount was at the time the third quarter was put to bed. FASB also decided that such earnings would not be considered extraordinary earnings. While this is likely to have been a once in a lifetime tax law change, they concluded that tax law changes were not unusual or extraordinary; they would have had to change the literature. This would have involved the FASB Board being involved in a process that would have taken much longer than did the Technical Bulletin route that was chosen.

Going back to the AICPA, they also have been working on reinsurance issues. Reinsurance has become a very popular subject both on the GAAP and on the statutory side. The current issue is that of accounting for loss portfolio transfers. Primarily a casualty issue, it can have application to life insurance companies. The issue involves loss portfolio transfer agreements which produce current profits when they are entered into, and which appear to be financing arrangements. The Insurance Companies Committee has produced a draft paper that will go to AcSEC later this month for consideration. In the paper, four conditions that a loss portfolio transfer must meet in order for the transaction to be considered reinsurance are established:

1. First, the covered losses must be reimbursed at least annually;
2. Secondly, commissions should be fixed and the ceding company should not participate in a substantial portion of the ultimate profit of the transaction;
3. Third, there should be no financial guarantees to the assuming company, and
4. Fourth, there should be no cancellation provisions contained in the agreement that would lead to a loss for the ceding company on cancellation.

Each of these items must be satisfied for the transaction to be considered reinsurance and not financing. And of great importance is the fact that the draft goes beyond these items. Let me read a portion of the draft "...the agreement should be considered a financing agreement if the primary results of the agreement is to provide financing." Thus, even if you meet the four rules, a specific transaction still could be considered financing. And they give an example that I think is very interesting. "For example, if the present value of the consideration paid by the ceding company, and the present value of the maximum expected reimbursement under the agreement calculated at current interest rates are substantially equivalent, the agreement is presumed to be a financing arrangement...". In other words, if what you pay is equivalent to the maximum you can get back, i.e., the present values are the same, the agreement is presumed to be a financing agreement. This example finally introduces a test that would have some teeth in it with respect to separating financing agreements from true reinsurance where there is a transfer of risk. As I said, this draft will be considered by the Accounting Standards Executive Committee this month.

Also in the reinsurance area, the AICPA is about to publish the Auditing Life Reinsurance Guide. They are looking at the galley proofs now and the final version will be out in early November I am told.

Let us now move over to the statutory side and discuss some of the things the NAIC has been doing. First, I will touch on some of the highlights of 1984 Annual Statement changes. Schedule DA for short term investments has been revised and is now in two parts. A part which has been added provides a verification between years, something that had been missing since short term investments were broken out of Schedule D. Schedule DB is a new schedule which will replace, in effect, Schedule D Part VII, and will report transactions in financial options and futures. Now that life insurance companies are starting to get into these investments, it was felt that they should be highlighted separate from other investments.

There has been a revised MSVR Calculation Form put into the annual statement reflecting the changes that the NAIC made in the MSVR calculation last December. The key changes deal with the bond and preferred stock component: now the amounts that will go into that component are graduated according to factors ranging from .5 to 3 depending how full that MSVR component is.

Schedule G, everyone's favorite schedule, has had its requirements raised to $60,000. Also, information on investments in subsidiaries has been added to the five-year historical data exhibit. In addition, an additional column for prior year reinsurance reserve credits has been added to Schedule S - Part 3A to accompany the existing current year credit. The objective is to enable the regulators to identify if there have been significant changes in reinsurance credits that might have affected the surplus level of the company. If there has been a major change in the reinsurance reserve credits, they will then look further to see whether that is what kept the company out of jail that year.

Also, a 150-page document has been produced providing new instructions for the life annual statement. (A similar document for the property and casualty statement also has been produced.) These instructions are not intended to set new standards for annual statement accounting. They are intended to add, in some cases at least, more specificity to the instructions for preparing the annual statement. Those instructions will be available only from the NAIC at the price of $150 a copy. So, if you would like to obtain a copy, you can get in touch with the NAIC in Kansas City. I would note that the ACLI did send out copies to their members, so you might already have one. But if you want the pages with 3-hole punch, a nice cover and provision for an annual update, the NAIC is the only party that will be supplying that in the future for a price.

I would also like to touch on a few current issues that the NAIC is dealing with that can be expected to lead to action in the near future. They are considering establishing accounting standards for Administrative Services Only (ASO) and Cost-Plus plans. It is believed that the accounting for these plans varies among the carriers, particularly among insurance carriers and Blue Cross/Blue Shield, and a group is working to develop standardized accounting requirements for such plans.

There is also another NAIC Group working on standardizing the accounting for annuity deposits. Currently, you are likely to find variation in practices among companies. You may find this business on page 4, line 1, or on line 1A, and in still other circumstances it will be shown on Page 3. So an attempt is being made by the NAIC to eliminate these varied accounting practices.

The equity method of accounting for subsidiaries is required under GAAP. The NAIC is considering what it should say about the equity method with respect to statutory accounting. The current accounting model indicates that it exists, but clearly doesn't think much of it. The study group that is working on this has concluded that it is a legitimate method of accounting, but for those companies that wish to use the equity method of accounting for subsidiary earnings, they will require special reporting in a supplemental annual statement schedule.

1985 will probably see the addition of a new Page 4A to both life and health and casualty statements. A new cash flow schedule has been developed for each and will be considered at the next Blanks meeting in 1985. The purpose of the new cash flow schedule is to better show the sources of cash from operations than does the current Page 4A, which starts with a net gain and backs out of the non-cash items. The proposed cash flow schedule would show cash premiums, cash claims, cash expenses and so on.

And one last item I might mention is the formation of an NAIC reinsurance study group. This group has not met yet, but it is expected that it will start to work on getting to the bottom of what many regulators believe are important solvency issues arising out of reinsurance transactions.

MR. JOHN O. MONTGOMERY: I am going to follow the outline of the report I submitted in Omaha.

(The report referenced by Mr. Montgomery is included as an Appendix.)

This is intended as an exposition of some ideas. I want to generate discussion on the matter and get ideas to help us as to where we might go. This is an evolving report, and I've learned enough at these sessions already to realize that there are some rather major changes that I am going to have to make and I will try and point those out along the way.

First of all, some general concepts. Any financial statement involving an insurance entity should relate the operations of that enity to those of all the other entities affiliated with it in the same corporate family. I am not going to make an attempt to develop this at this time, but I think this is a matter requiring research to see how to do this. We do have that problem and one of the things that you will see as you get into the details is that when we have a blank, the blank is designed so that it can cover not only that insurance company, but its whole corporate structure, and, hopefully, it can give an entire picture. We've had a tremendous amount of difficulty, as you well know, with several large annuity writers, with the activities going on in the holding company which led to difficulties in the insurance companies and the way the assets were transferred and replaced. Some of the assets of the insurance company, which were good assets, were replaced by those that were not appropriate for that company and we've got to get better control of that. That is the reason for this approach. Of course, that requires a change in the Holding Company Act, and that makes it a long range project.

The balance sheet, summary of operations and cash flow formats should be common for all lines of business if you want to analyze a common statement for an entire holding company operation or an entire group of companies. The balance sheet, summary of operations, capital and surplus account and Schedule T should be submitted on or before the date now specified for the presentation of the blank and all other exhibits. When I wrote this I said all other exhibits should be required one month later. I am not sure that is really necessary and now realize we need the 5 year historical data with this initial submission, primarily because that is where we get our basis and any other information needed for our early warning system. All solvency tests should be in there too, so that we have that for the initial collection. On the matter of the data submitted later, it's now considered that because of the great detail of data and supporting exhibits needed that large and medium sized companies or any company that has computer facilities would submit data in computer form to the NAIC and the NAIC would give to the regulators any reports they needed or wanted to have. I've already heard some objections from some regulators that they would not get it soon enough. So we will have to work on just what information is needed and maybe all that data has to be submitted at the same time. These are all problems that we will have to work with as we develop this change in format.

Incidentally, I want to point out that what is being discussed here is a complete change in the basic format of the blank from what it has been over the last 100 years. It is a total reorganization and it can't happen overnight. It has to be an evolutionary process because you just can't make such drastic changes without retooling everything. It shouldn't change the basic accounting structures of the companies but just the way the data is presented.

Getting on with the balance sheet, the balance sheet should be presented not only for the entire insurer, and possibly its holding company, but for each line of business for which assets and/or liabilities are segregated and possibly by blocks of business. In fact I can see this coming. The annuity business may have its entire class of business segregated as to assets and liabilities. Universal life may end up that way. We don't know where we are going on this. The blank should be more flexible so that we can try and anticipate possible future developments within the industry on where various products are going and what their needs might be with respect to financial reporting.

The balance sheet should reveal both the market and statement value of assets as well as the liabilities payable on demand. This is a new item. These include all cash values for life companies and for casualty companies, such as amounts that would be payable as refund of premium or anything that would be payable on demand.

We have in the surplus section an item called risk surplus. Originally, and that is the way it looks here in my write-up, I thought it should be disclosed. Now, thinking back on what's happened with the annuity companies, where information got out into the press that was possibly derogatory with real adverse consequences to the companies, I feel that perhaps the risk surplus should be a confidential item which would be in the same class as the examiner team reports to the NAIC. So risk surplus should be something that would be internal and only revealed publicly in the case of stringent financial difficulty and if the company were taken over by the regulators in some form of rehabilitation. But I think having risk surplus, which is the main field of operation for the valuation actuary, puts a great strain on the valuation actuary if his/ her views on the level of risk surplus should suddenly be publicly revealed and possibly cause a run on the company. So I agree with what was relayed to me already at this meeting that risk surplus should probably be a confidential item. The risk surplus is the summary of all of the C-1, C-2, C-3, and C-4 risks.

On the summary of operations, we've set it up to relate only to the operations related specifically to the current year, but in somewhat of a different form. If you are familiar with the casualty blank, you will recognize the three sections: Underwriting Operations, Investment Operations, and Non-Insurance Operations. Then the summary of operations is presented in total and separately for each line of business on each page. Each of the summaries of operations would be split into direct, ceded, assumed and net; so that we get an entire picture of the reinsurance structure of a company. This has been one of our biggest problems in regulation - to try and figure out just what was happening with respect to reinsurance in a particular company. You can see why this is going to generate a lot of discussion.

I have a cash flow statement that may not appear to be like the one the NAIC is going to propose right now, because I wanted to depart from it and simplify it. Incidentally, the format of the summary of operations follows rather closely what was proposed some years ago as a so called "simplified" blank. The reason for that is that I think you need to remove a lot of the extraneous items and just get to the meat of it for the general statement. These extraneous items can appear in the detailed exhibits and schedules that accompany the blank so that you have a full explanation and the detail. For anybody looking at the blank directly just to get some general information, I think we need a simplified form.

I've listed some supporting exhibits and schedules and I will go into the problems a little bit later. Since this is so long, I am not going to go through the entire thing, it would take much too long here. I am hoping that all of you here and some that are not here will come to the open forum in St. Louis where everybody will have a chance to express their views after they've digested what I have here and later versions of this which will be coming out so that we can really get an idea of what we can do and what we can't do or where we have problems. The purpose of any discussion here and the discussion in St. Louis is to identify the areas really needing work. After that I anticipate that the NAIC Blanks Committee will appoint a study committee at its March meeting and that we will form an advisory committee soon after, probably right after we have the open forum in St. Louis. Hopefully, I can obtain some people to serve on advisory committees after finding out who objects the most.

I might point out that the "policyholder benefits" are all of the benefits which are payable, which includes a number of items which are now just separate items in the blank and is designed to include all of the benefits available to policyholders. All of the details of that would be in supplemental exhibits.

One of the noteable features of the summary of operations is in the "underwriting income" where we show the premium income and the income coming in for deposits and then we deduct from that the increase in reserves excluding the amount of tabular interest that is required to maintain those reserves or the interest on deposits which is credited to those accounts. Under "investment income" we show the investment income less tabular interest and the amount credited to the deposits. We found out in our review of the annuity companies that this item of investment income less tabular interest or amounts credited on deposit is a very important regulatory test and the material in this blank is designed to furnish us better surveilance techniques.

I might point out that in Canada they have quite a few less companies to watch and it's much easier to maintain contacts with the valuation actuaries than it is in the United States where we have some 1500 life companies and some 1600 casualty companies. So in order to do that we have to have a more detailed computer surveilance program and one of the main purposes of having so much detail on the blank is to provide better surveilance information. Having submitted all the details in the form of computer records we would have in the NAIC data base much more information than we have now which could be used to do other studies on surveilance and, as the need arises, for certain areas to be considered in more detail. The small companies, you have to remember, may have only one or two lines of business in which case they won't really have as much to report. But there is a problem with small companies in reporting all of this and we have to work out some shortcuts for them.

The exhibits that I have listed here are tentative at this time. What I find out and what develops from these discussions will assist in shaping the content and form of the exhibits. I have one for "premiums and considerations", and another one for "net funds placed on deposit". That exhibit would show the funds placed on deposit and funds withdrawn from deposit. The "policy reserve" and "deposit fund liabilities" are pretty much like we now have in Exhibits 8, 9 and 10. Under that there are several parts: the aggregate policy reserves on a statutory basis, deposit fund liabilities, a consistency of fund development and consistency of statutory reserve development. This is really a check item on whether reserves are developing consistently. It is really a form of the present Page 6. These may not be the same for all lines of business. Each line of business may have its own format for these various exhibits. Casualty lines will have their own format, the life lines will have their own format. This is something that has to be worked out through this study group. We have a lot of work to do here. A lot of the lines of business will have similar approaches, but because of the distinctive measures of each line of business I would expect all of the supporting exhibits and schedules to be somewhat different by line of business.

I think most of these exhibits follow through with what we presently have. They are numbered differently but you can probably recognize them as things we already have. I'm not sure whether the exhibit on risk surplus is really needed or whether we need just the statement of the valuation actuary. This is something we have to work out. I think you will find that most of what I presented here is in a very tentative form. It's intended to stimulate discussion and get people thinking how to do these things and what has to be presented with these various items. That's the sort of thing I am asking your assistance on. This should also be done in the Casualty Actuarial Society, because we need assistance in their area. I am hoping that they can come along with that. We can work with the two committees of the Academy on a way of going about this. This has to be a joint effort from the whole profession.

MR. ALBERT K. CHRISTIANS: I have a whole list of questions. I will start with one that has to do with current NAIC and state reporting for John. We are starting to get into trouble in particular states, Michigan, South Carolina, and Tennessee. When we file our statement with them, they go through Schedule S, see a company not admitted in their state and cross it out. Now we may have to have a different statement for every state. Is there any way we can get this back to where we can have just one statement? These states are not allowing reinsurance reserve credits for companies not admitted in their state, even though we are not domiciled in their state. The reinsurer is an authorized reinsurer in our state of domicile, but they are not accepting our statement because we are taking a reserve credit for a company that is not admitted in their state. I don't see why they don't accept the valuation of the state of domicile.

MR. SCHREINER: In June the NAIC adopted a model reinsurance credit bill that specifies the conditions under which not admitted companies can be considered for credit. If the companies fail those tests...

MR. CHRISTIANS: But the NAIC thinks that this is an acceptable situation where you have to file a different statement in every state if you have a reinsurer who is not admitted in every state. Is that o.k. with the NAIC that we have to do that?

MR. SCHREINER: This is probably not the right forum to debate that.

MR. WILLIAM G. POORTVLIET: John, I want to congratulate you on the thrust of your letter and the recommendations which would be an attempt to bring the annual statement blank into modern times. I think we all welcome that effort. I was also pleased to hear that you were on several of the groups that Mr. Schreiner had spoken of. I guess the earlier report we had with respect to the Canadian situation, where you have the statutory blank and the effort to bring it into the current scene moving together with the accountants, prompts me to ask you how you feel about the progress that's being made with respect to interchange of ideas and approaches between the commissioners and these accounting bodies that are also studying matters that are very important to, not just the stockholders, but policyholders of the companies. Do you see these groups by reason of your presence on some of the committees and perhaps other avenues of contact coming together more down the road than may have been the case in the past, John?

MR. MONTGOMERY: Yes, especially since my commissioner is a member of the AICPA. I think that has a great influence - my commissioner being a CPA.

It is going to help a great deal in getting things together, I think.

MR. HENRY B. RAMSEY: I thought this was an extremely fascinating presentation. Particularly, Horace, the work in Canada. As you listen to the progress that has been made between actuaries and accountants working together to get a sound system, it is really exciting. I hope it inspires us in the U.S. to do likewise. A detailed question on the proposal about foreign currency, where you expect the recommendation is to reflect the current value in the statement. How will the change in that value be accounted for?

MR. MCCUBBIN: I will read you two recommendations from the Task Force Report which I think are in response to your question.

"That a special deferred foreign currency translation can be established for the realized and unrealized translation gains and losses resulting from the process and should be disclosed separately from other balance sheet items. The opening balance should be calculated as the aggregate effect of translating all foreign currency assets and liabilities at current exchange rates at the beginning of the year for which recommendations are first applied."

MR. SCHREINER: I have a quick question of John. Considering that the NAIC's annual statement has grown to the extent it has, there must be a constituency for detail. Do you really think it is possible to get the financial examiners to accept a statement that condenses much of the detail that they now have?

MR. MONTGOMERY: It is interesting that you should ask that question. I did have a conversation with Mr. Tom Powers, who, as you know is sort of a renegade. He's the Chief Deputy in Wyoming. It was his idea to use this computer approach to getting the details; he thought it would be a great idea. Most of the insurance departments don't really get around to reviewing all of that detail until at least a month after the blank comes out. Now, I do know that Wisconsin would like to get the information right now because they want to do it all in the first month. So it is for states like that we that we may have some problems and we may have to get certain information. We have to find out what details they use for their financial reviews, what details most states use, and then see that somehow they get the information. Otherwise the great mass of detail, as far as I am concerned, could come out of the computer and you don't need to publish it. It should be available on demand. It is a public document and so, if somebody does want the bond schedule for Metropolitan, they should be able to get that. But that could be done by a special printout through the NAIC.

MR. CHRISTIANS: John, it seems that you are suggesting to keep the risk surplus secret. Is it a proposal to keep the policyholders ignorant of significant information that affects them for their own good? You probably would be better off having continuous and timely disclosure of the risk surplus so you wouldn't get sudden runs. Rather, the policyholders would always know what position their company was in.

MR. MONTGOMERY: I discussed this, and there are other ways of getting at this without going that route. I don't want to put the valuation actuary out on a limb on this thing, but there are certain surveillance tests which A. M. Best or others may want to put out using the data available. In that respect, the information that is publically available could be used to generate certain items which would get around putting the valuation actuary on the spot. I presume that this is what's going to happen.

MR. CHRISTIANS: I have a question for Mr. Schreiner about financing arrangements. My company is getting more and more into these and in GAAP it presents a curious situation in that you may have outstanding obligations that you don't report on your statement, or policies that are in somebody's statutory blank that you still are holding deferred acquisition costs on. Is there likely to be any guidance on GAAP treatment of these financing arrangements? It's briefly mentioned in the audit guide, but evidently there has been more activity in this area since the audit guide was promulgated.

MR. SCHREINER: There are existing general GAAP guides on how you account for financing.

MR. CHRISTIANS: I guess I am more curious how you decide what's a financing arrangement and what's not.

MR. SCHREINER: That is the issue they are dealing with and that's what this latest draft paper is dealing with.

MR. CHRISTIANS: You spoke of it in terms of loss reserves; we have it in life reinsurance as well. Where is some clarification for life companies?

MR. SCHREINER: What they are doing is responding to the specific issues as they see them. They have a more general task for them to deal with reinsurance accounting.

MR. CHRISTIANS: I can imagine there are going to be more cases on the border line because you have pressures from the states that you do have to have a significant transfer of risk to have a reinsurance agreement, and yet for the financing arrangement you are not supposed to. We're going to have some hard calls to make there.

MR. SCHREINER: They will get to the general issue in an appropriate time frame presumably. But what they've dealt with now is this sore thumb that is sticking out where everybody says "hey, how can you let that happen?" So they are trying to tape that down in the mean time.

MR. THOMAS G. KABELE: I have comments on the statutory accounting. First of all, I think the proposed market value and the demand liability schedule are quite good. Also, the separate reinsurance reporting for assumed and ceded are quite revealing. One other comment, we've had certain troubles comparing our company with other companies because Exhibit 2 does not show a non-loaned yield rate. It just shows a yield rate that is garbled up by policy loans. It would be very helpful if we could have two yield rate calculations. Also, we've got a lot of tax exempt mortgages and some tax exempt real estate and it would be handy if Exhibit 3 could be modified to show separate lines for those items.

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, *Governor*

DEPARTMENT OF INSURANCE
600 SOUTH COMMONWEALTH AVENUE
LOS ANGELES, CALIFORNIA 90005

September 10 , 1984
(Edited September 14, 1984)

TO: MEMBERS OF THE NAIC BLANKS TASK FORCE

THE NAIC ANNUAL STATEMENT BLANK
- Where Do We Go From Here?

In view of such crises as the Baldwin United single premium deferred annuities, the Kenilworth reinsurance capers, the spectre of integrated financial services and, in fact, the entire gamut of regulatory problems induced by the holding company manipulations, takeovers and other conglomerate activities how can you believe that the present NAIC Annual Statement Blank is an adequate financial report? It is a product of the nineteenth century that has long outlived its usefulness.

Some years ago an attempt was made to "simplify" the annual statement blank and many good ideas were presented for such "simplification". However the real problems were never faced. The time has come for a thorough overhaul which, because of the monstrous transformation problems inherent in such an activity can only be accomplished slowly over a period of years.

This paper is intended to stimulate thought on that overhauling process. Several concepts have been evolving over the past ten years which now appear to be reaching fruition. Some of these are embodied in the work of the Society of Actuaries Committee on Valuation and Related Problems which has defined various risks to which an insurer is subjected to and which is now developing the concept of the "valuation actuary".

The ideas and formats presented here are for the purpose of discussion to determine what shape the new financial reporting structure should evolve into. Attached are a balance sheet, summary of operations and cash flow statement. More details are to be presented later.

1. Concepts

   1. General Concepts
      (a) Any financial statement involving an insurance entity must relate the operations of that entity to those of all the other entities affiliated with it in the same corporate family. (No attempt is made at this time to define the details of such relationship)

(b) The balance sheet, summary of operations and cash flow formats should be common for all lines of business.

(c) The balance sheet, summary of operations, Capital + Surplus Account and Schedule T should be submitted on or before the date now specified for presentation of the blank. All other exhibits and schedules should be required one month later.

2. The Balance Sheet

(a) A balance sheet should be presented for not only the entire insurer (and possibly its holding company) but for each line of business for which assets and/or liabilities are segregated.

(b) The balance sheet should reveal both the market and statement value of assets as well as liabilities payable on demand, policy reserve liabilities on a statutory basis and a "risk surplus" item (plus or minus) to provide for risks not elsewhere considered. The minus adjustment would be considered to the extent that the reserves developed by statutory definition are considered to be redundant and would release more surplus to a "venture surplus" position defined further in the material attached.

3. The Summary of Operations

(a) The summary of operations should apply only to operations related specifically to the current year and should be in three parts:
   (1) Underwriting Operations
   (2) Investment Operations
   (3) Non insurance Operations

(b) The summary of operations should be presented in total and separately for each line of business (some of which may be split into sublines), for corporate operations, for administrative service only operations and for all other non insurance operations combined (where this last item is large it may also be split).

(c) Each summary of operations should be presented on a separate page in four columns:
   (1) Direct Business
   (2) Reinsurance Ceded
   (3) Reinsurance Assumed
   (4) Net Business

4. Cash Flow Statement

The cash flow statement should be parallel in form to the operations statement showing all cash transactions. The exhibits supporting and detailing the items in the operations statement should also show the related cash transactions in the same detail.

5. The Capital + Surplus Account

This report is needed at least for every insurer and for its parents or upstream companies. It may be needed for special blocks of business whose assets have been segregated or separated.

6. Schedule T

A schedule of premiums paid by state should be included for premium tax purposes which will be split by major groups of business and may require more than one page.

7. Supporting Exhibits and Schedules

The present investment schedules would be retained close to the present format. The supporting exhibits will vary with the line of business and may vary widely.

8. Account Structure

The new report structure should disturb the account structure as little as possible.

II. Problems

1. Special legislation will probably be needed. This is particularly true of statements involving holding company or conglomerate controlled insurance companies.

2. The actuarial profession is not currently generally technically qualified to provide the degree of service required.

The professional societies are heavily involved in re-training actuaries for these purposes and within a few years will be able to establish adequate levels of competency. It is doubtful that the blank will be ready by that time so that this may not be a real problem.

3. Computer surveillance systems must be redesigned. This is needed regardless of the reporting blank format.

4. Small and medium size insurers may find the reporting system too complex for their operations. Shortcuts using acceptable reporting practices must be defined.

5. The new reporting system may disturb the federal taxation of insurance company legislation. This problem will require careful consideration.

III. Conclusion

The NAIC Blanks Task Force should set up a special study group to review the ideas presented here. This subject will be presented to the Society of Actuaries at its Toronto meeting in October 1984 and in more detail at its meeting in St. Louis in May 1985. Any study group designated by the NAIC should be prepared to spend at least three years on the project and possibly a considerable time beyond that. Since the review would cover all blanks, that should be considered in designating a study group and its advisory committee.

John O. Montgomery

JOHN O. MONTGOMERY, FSA, MAAA
Chief Actuary and
Deputy Insurance Commissioner

JOM:ets

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Attachment

Discussion Draft - Statement Features

General Considerations

(1) Several items in the present blank may be combined under one item which is then detailed in a supporting exhibit. (The "simplified" blank proposed several years ago also contained this feature).

(2) Some supporting exhibits may be more complex, combining several exhibits or pages in the current blanks. Many exhibits vary in format by line of business so as to preserve some more traditional reporting features.

(3) This "discussion draft" is only intended as a starting point and in some areas is intentionally incomplete so as to allow more room for imaginative thinking.

(4) The present accounting structure should be minimally disturbed if possible.

Assets

(1) Both the market value and the statement values are shown for bonds which are also split between those "Maturing in one year less" and "Other" for the market values.

(2) Affiliated company assets included in the total assets are shown in separate columns for the current and previous years.

Liabilities, Surplus and Other Funds

(1) Because of potential crises in a rapidly shifting economic environment base points for reserve liabilities and funds on deposit are needed. These are the amounts payable on demand to policyholders in the form of cash. This includes cash surrender values and funds on deposit which are surrenderable reduced by current surrender charges. Where bail-out provisions exist the surrender charges would be included in "other" which includes also all other differences between statutorily required reserves and liabilities and the amounts payable on demand. For lines of insurance other than life insurance or annuities there may be no such item as "amounts payable on demand" but for consistency in consolidated blank the format should be retained. However for some lines of business the "amount payable on demand" could mean the amount of pro rata premium available less any surrender charge available in the event the insurance contract were terminated as of the valuation date.

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(2) The reserves and liabilities excluding those related directly to the payment of policyholder benefits dividends or coupons are those analogous to the unearned premium reserves for most casualty, liability and indemnity lines of insurance and for the aggregate reserves for the life insurance and annuity lines of business.

(3) The "Policyholder Benefits" liability is the claim or loss reserve.

(4) The "Risk Surplus" is a combination of several facets related to actuarial analysis testing the redundancy or insufficiency of statutory reserves. It comes about through consideration of each of the four major risk areas currently identified by the Society of Actuaries Committee on Valuation and Related Problems. It includes a further adaptation of the Mandatory Securities Valuation Reserve, which is the only risk currently considered in the NAIC Blank. The other three risk areas are the inadequacy of investment income, the inadequacy of premium rates and the inability to meet unexpected external conditions. The last risk includes but is not limited to adverse court decisions, legislation and regulatory actions as well as punitive damage awards.

(5) "Venture Surplus" could be defined as the surplus remaining after deducting "Risk Surplus" and which is the surplus which is available either for distribution to stock or policyholders or for going into new spheres of activity or for expanding current spheres of activity.

Operations Statement

(1) A format analogous to that of the Casualty Blank is the proposed split into underwriting operations; investment operations and other operations.

(2) This approach entails splitting out from the increase in reserves the statutory interest required to maintain those reserves (like the tabular interest in the present page 6 of the life and health annual statement blank); and also splitting out from the increase in deposit funds the amount of interest credited to those accounts.

(3) The premiums and considerations and net funds placed on deposit are reduced in the underwriting operations by the increase in reserves described above in (2) to obtain such income applicable to the current operation year.

(4) The investment operations analysis derives the position of the net investment income and realized gains remaining after deducting interest required to maintain the policy reserves and interest credited to policyholders deposit accounts.

Attachment

(5) "Other income" is all income not related to insurance or insurance related investment operations. For a consolidated conglomerate or holding company it would include all such income in consolidated form for parents and affiliate corporations.

(6) The capital account is not included in the material since it probably should not differ materially from the present format.

Exhibits

(1) The numbering of these is purely tentative at this time and should be reviewed.

(2) The exhibits may vary by line of business but should directly derive and support the items shown in the operations and cash flow statements separately for each line of business for which an operations statement is prepared as well as furnishing details for some assets and liabilities.

Exhibit 1 Premiums and Considerations

Exhibit 2 Net Funds Placed On Deposit

This exhibit should show funds placed on deposit and funds withdrawn from deposit.

Exhibit 3 Policy Reserves and Deposit Fund Liabilities

This exhibit is in several parts for most lines of business.

Part A Aggregate Policy Reserves on a Statutory Basis

Section 1 Statutory Reserve liabilities as of the date of valuation

This is analogous to the life blank exhibits 8, 9, and possibly a part of 11, and to the unearned premium reserve liability for the casualty blank.

Section 2 Consistency of Statutory Reserve Development

This is an analysis similar to that now performed on Page 6 of the present NAIC Life Blank.

Part B Deposit Fund Liabilities

Attachment

Section 1 Funds held as of the date of valuation

(Analogous to exhibit 10 of the present life blank). This includes premiums paid in advance and accumulated coupons and dividends as well as all other deposit funds. (Some study is needed to determine the status of group Deposit Administration Funds).

Section 2 Consistency of Fund Development

This is analogous to Section 2 of Part A.

Part C Amounts Payable on Demand

This part includes all such amounts payable in cash including separate entries for such items as cash surrender values payable, at statement date, the cash values available at statement date of deposit funds held, pro rata premiums less surrender charges if any, and any other amounts payable on demand.

Part D Increase In Policy or Contract Reserves and Deposit Fund Liabilities

This report is in two sections

Section 1 Consistency of reserve or liability development

This is in two subsections one for policy reserves and the other for deposit funds and each is in a format analogous to that of Page 6 in the present Life and A&H Blank.

Section 2 Net Increase Reserves or Funds and Required Interest Income

For this section all reserve and fund items are combined. The section shows three items:

(1) Increase in reserves and funds in deposit (from Section D, last item less first item).

(2) Required interest on reserves and deposit funds - To item 18 of the operations statement. (From Section D, the sum of tabular interest on policy reserves plus interest credited on deposit funds).

(3) Net Increase in reserves and deposit funds - to Item 3 of the Operations Statement (Item 1 less Item 2 of this section).

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Attachment

Exhibit 4 Benefits to Policyholders

Part A Summary

This will differ by line of business but will be split by direct, reinsurance ceded, reinsurance accepted, and net for each item. Such items as death claims, surrender values paid, endowments paid, health insurance benefits paid, annuity payments, disability income and each of the forms of casualty, indemnity and liability insurance benefits. Obviously this exhibit will vary by line of business.

Part B Development of Benefits Paid

This part starts with cash payments and develops the benefit payments shown in Part A wherever that development is needed. Again this is split by Direct, Ceded, Assumed and Net.

Part C Reserve Development For Direct Business

(Reserve development for reinsurance is given in Exhibit 17) Schedules O and P best of the Casualty Blank best represent what is needed here. Other formats may be appropriate for other lines of business.

NOTE: The discussion draft for this exhibit is necessarily sketchy to invite comments on how these developments should be handled for various lines of business.

Exhibit 5 Other Policyholder Transactions

This exhibit gives the details of such transactions as reserve transfers on group conversions, policy change transaction net results, structured settlement transactions (?), and any other miscellaneous transactions. This exhibit covers all write in items concerning policyholder benefits.

Exhibit 6 Commissions and Expense Allowances

Exhibit 7 General Expenses

This is in four parts

1. Investment expense
2. Claims settlement expense
3. Other general insurance expense

Attachment

4. Other expense (this last item could include expenses incurred in the operation of administrative service only contracts as well as expenses incurred in non insurance operations).

Each part includes an operation statement and liability analysis.

Exhibit 8 <u>Taxes, licenses, and fees other than Federal Income Tax</u>

This is in two parts, one concerning insurance operations and the other non insurance operations. Each part includes an operation statement and a liability analysis.

Exhibit 9 <u>Net Transfers</u>

This concerns the details of all transfers of funds between lines of business other than those in Exhibit 5. Note that this also includes a liability analysis as well as an operation statement analysis.

Exhibit 10 <u>Other expense or tax related items excluding Federal Income Taxes</u>

This is a miscellaneous catch-all detailing such write in items.

Exhibit 11 <u>Net Investment Income</u>

This is analogous to the present Exhibit 2 except that it also involves an allocation by line of business.

Exhibit 12 <u>Capital Gains or Losses</u>

This includes separate sets of items for realized and unrealized capital gains or losses.

Exhibit 13 <u>Other Income</u>

This includes all non insurance operation income such as from administrative service office operations and, where applicable, income from non insurance affiliates and corporate operations.

Exhibit 14 <u>Coupons + Dividends to Policyholders</u>

This includes both the operation statement and liability phases of this activity.

Attachment

Exhibit 15 Federal and Foreign Taxes Incurred

This details the development of such taxes and the allocation by line of business. The degree of detail is open to discussion.

Exhibit 16 Other Invested Assets

This includes each write-in invested asset as a separate item.

Exhibit 17 Assets and Liabilities Related to Reinsurance Operations

This is a mini-balance sheet for items related to reinsurance operations.

Exhibit 18 Assets and Liabilities Related to Premium Collection

Exhibit 19 Assets Related to Investment Income

Exhibit 20 Other Assets

These are assets not elsewhere identified

Exhibit 21 Risk Surplus

This is detailed in this exhibit by category of risk and supported by an actuarial statement of opinion by the Valuation Actuary. The statement of opinion will be supported by a detailed analysis which is not to be included as part of the annual statement but is to be made available on demand by a regulator. Such demand will not normally be made unless the company is experiencing financial difficulties.

Exhibit 22 Amount of Indebtedness

An agreement for surplus relief between two insurers, which has been deemed not to be a transfer of risk, will be treated as a loan by the assuming company to the ceding company. This exhibit is to reveal the terms of such agreements.

Exhibit 23 Other Liabilities

Miscellaneous or write-in liabilities not elsewhere identified.

Exhibit 24 Special Surplus Funds

Details of such funds are identified in this exhibit.

Exhibit 25 Cash Investment Transactions

Part A Cash Disbursed for Purchase of Investments
Part B Cash Received from Sale of Investments

Exhibit 26 Affiliate Transactions

Part A Balance Sheet Details
Section 1 Assets - Receivable from Affiliates
Section 2 Liabilities - Payable to Affiliates

Part B: Transactions
These are for incurred and cash separately
Section 1 Paid to affiliates
Section 2 Received from affiliates
(Including capital infusion)

NOTE: This is a very sketchy description for this exhibit. Much study is indicated, especially considering what happens when an affiliate is the reinsurer. Perhaps Exhibit 17 should concern only reinsurance with non affiliates while Exhibit 26 would include reinsurance with affiliates.

AS OF ____________________
LINE OF BUSINESS ____

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ASSETS

	Affiliated Company Current Year	Affiliated Company Previous Year	Total Assets Current Year	Total Assets Previous
1. Bonds				
1.1 Maturing in One Year or less (market)				
1.2 Other (at market value)				
1.3 Subtotal				
1.4 Adjustment to Statement Value				
1.5 Statement Value				
2. Stocks				
2.1 Preferred stocks				
2.2 Common stocks				
3. Mortgage loans on real estate				
4. Real Estate				
4.1 Properties occupied by the company (less $__________ encumbrances)				
4.2 Properties acquired in satisfaction of debt (less $__________ encumbrances)				
4.3 Other properties (less $_______ encumbrances)				
5. Collateral loans				
6. Short term investments				
7. Other invested assets (Exhibit 16)				
8. Cash on hand and on deposit				
9. Total cash and invested assets				
10. Assets related to reinsurance operations (Exhibit 17)				
11. Assets related to premium collection (Exhibit 18)				
12. Assets related to investment income (Exhibit 19)				
13. Electronic data processing equipment				
14. Federal income tax recoverable				
15. Receivable from affiliates (Exhibit 26)				
16. Other assets (Exhibit 20)				
17. Total Assets				

AS OF ____________________
LINE OF BUSINESS ____

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LIABILITIES, SURPLUS AND OTHER FUNDS

			Current Year	Previous Year
1.	Aggregate reserves excluding those related directly to the payment of policyholder benefits, dividends or coupons			
	1.1 Amounts payable on demand	Exhibit 3C		
	1.2 Other (Item 1.3 less Item 1.1			
	1.3 Total	Exhibit 3A		
2.	Funds on deposit for policyholders			
	2.1 Amounts payable on demand	Exhibit 3C		
	2.2 Other (Item 2.3 less Item 2.1)			
	2.3 Total	Exhibit 3B		
3.	Policyholder benefits	Exhibit 4		
4.	Policyholder coupons and dividends excluding accumulations and paid up additions	Exhibit 14		
5.	Related to reinsurance operations	Exhibit 17		
6.	Related to premium collection	Exhibit 18		
7.	Investment income related	Exhibit 11		
8.	Claims expense	Exhibit 7		
9.	General insurance expense	Exhibit 7		
10.	Insurance taxes, licenses + fees excluding federal income tax	Exhibit 8		
11.	Federal income tax	Exhibit 15		
12.	Net transfers	Exhibit 9		
13.	Amount of indebtedness	Exhibit 22		
14.	Amounts payable to affiliates	Exhibit 26		
15.	Other Liabilities	Exhibit 23		
16.	Total liabilities			
17.	Risk surplus	Exhibit 21		
18.	Special surplus funds	Exhibit 24		
19.	Capital paid up			
20.	Gross paid in and contributed surplus			
21.	Unassigned funds			
22.	Less treasury stock at cost			
23.	Venture surplus (Items 18 through 21 less Item 22)			
24.	Total Capital + Surplus (Item 17 + Item 23)			
25.	Total Item 16 + Item 24 (Page 2, Item 17)			

FOR THE YEAR OF ________________ Page All
LINE OF BUSINESS ______________________________

OPERATIONS STATEMENT

UNDERWRITING OPERATIONS			DIRECT BUSINESS	REINSURANCE		NET BUSINESS
				CEDED	ASSUMED	
NET INCOME						
1.	Premiums and considerations	Exh. 1				
2.	Net funds placed on deposit	Exh. 2				
3.	Net Increase in policy or contract reserves and deposit fund liabilities	Exh. 30				
4.	Premiums, considerations, and deposits applicable to the current year (Item 1 + Item 2 - Item 3)					
DEDUCTIONS						
5.	Benefits to policyholders	Exh. 4				
6.	Other policyholder transactions (net)	Exh. 5				
7.	Subtotal (Items 5 and 6)					
8.	Commissions and Expense Allowances	Exh. 6				
9.	Claims settlement expense	Exh. 7				
10.	Other general insurance expense	Exh. 7				
11.	Insurance taxes, licenses and fees excluding Federal Income Tax	Exh. 8				
12.	Net transfers	Exh. 9				
13.	Other expense or tax related items excluding Federal Income Tax	Exh. 10				
14.	Total (Items 7 through 13)					
NET UNDERWRITING GAIN OR LOSS						
15.	Total (Item 4 less Item 15)					
INVESTMENT OPERATIONS						
16.	Net investment income	Exh. 11				
17.	Realized capital gain (+) or loss (-)	Exh. 12				
18.	Required interest income	Exh. 30				
19.	Interest on policy or contract funds					
20.	Net investment gain (+) or loss (-) (Item 16 + Item 17 - Item 18 - Item 19)					
SUMMARY OF OPERATIONS						
21.	Other Income	Exh. 13				
22.	Net income before dividends to policyholders and before federal and foreign taxes					
23.	Coupons and Dividends to policyholders	Exh. 14				
24.	Net income after dividends to policyholders but before federal and foreign taxes (Item 22 - Item 23)					
25.	Federal + foreign taxes incurred	Exh. 15				
26.	Net gain (or loss) from operations (Item 24 - Item 25)					

FOR THE YEAR OF ______________
LINE OF BUSINESS ______________________________

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CASH FLOW STATEMENT

UNDERWRITING OPERATIONS			DIRECT BUSINESS	REINSURANCE CEDED	REINSURANCE ASSUMED	NET
CASH RECEIVED						
1.	Premiums and considerations	Exh. 1				
2.	Deposits (Gross)	Exh. 2				
3.	Policyholder transactions	Exh. 5				
4.	Subtotal Items 1 through 3					
CASH DISBURSED						
4.	Benefits to policyholders	Exh. 4				
5.	Other policyholder transactions	Exh. 5				
6.	Commissions and Expense Allowances	Exh. 6				
7.	General Insurance Expense	Exh. 7				
8.	Insurance taxes, licenses fees excluding Federal Income Tax	Exh. 8				
9.	Subtotal Items 4-8					
NET CASH FLOW FROM UNDERWRITING OPERATIONS						
10.	Total (Item 4 less Item 9)					
INVESTMENT OPERATIONS						
CASH RECEIVED						
11.	Dividends and interest income	Exh. 11				
12.	Proceeds from sale of investments	Exh. 12				
13.	Rents and royalties	Exh. 11				
14.	Other investment income	Exh. 11				
15.	Subtotal Items 11-14					
CASH DISBURSED						
16.	Purchase of investments	Exh. 25A				
17.	Interest on policy or contract funds					
18.	Investment expense	Exh. 11				
19.	Investment taxes, licenses + fees excluding Federal Income Tax	Exh. 8				
20.	Other Investment disbursements	Exh. 11				
21.	Subtotal Items 16-20					
NET CASH FLOW FROM INVESTMENT OPERATIONS						
22.	Total (Item 15 less Item 21)					
OTHER OPERATIONS						
CASH RECEIVED						
23.	Proceeds from sale of investments	Exh. 25B				
24.	Capital infusion from parent or, affiliate or sale of stock	Exh. 26				
25.	Other cash received	Exh. 13				
26.	Subtotal Items 23 - 25					
CASH DISBURSED						
27.	Coupons + dividends to policyholders	Exh. 14				
28.	Corporate expenses	Exh. 13				
29.	Federal Income Tax	Exh. 15				
30.	Other disbursements	Exh. 13				
31.	Subtotal Items 27-30					
NET CASH FLOW FROM OPERATIONS OTHER THAN UNDERWRITING OR INVESTMENTS						
32.	Total (Item 26 less Item 31)					
TOTAL NET CASH FLOW						
33.	Total (Items 10 plus 22 plus 32)					