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GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) FOR NEW GENERATION PRODUCTS

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- Update on Federal Accounting Standards Board (FASB) proposal
- Incidence of earnings
- Accounting rules and product design
- Recoverability and loss recognition

MR. JAMES B. MILHOLLAND: I intend to talk about the accounting rules in the FASB proposal, which covers a wide variety of products and includes items you perhaps did not know were covered. Mark is going to talk about some of the proposals' implications with respect to design of Universal Life products.

GAAP ACCOUNTING FOR NEW GENERATION PRODUCTS

Let's take a look at the FASB proposal in its entirety and see what it says and what it means. The official title is "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Insurance Contracts and for Realized Gains and Losses from the Sale of Investments." We will talk about what the proposal is and the rationale for the proposal, how it affects earnings, the industry's response, and the public's reaction to the rules. Finally I will make a couple of bold predictions about what will happen.

Looking at the FASB proposal as a whole, it covers more than Universal Life. It begins by classifying products into four categories. Traditional products are products that we are accustomed to from the pre-Universal Life days, such as Par Whole Life and Non-Par Whole Life. FASB concluded that accounting for these products should not be revisited. Traditional policies will continue to be accounted for under rules set by FAS 60. Universal Life-type policies will come under the new rules when they become effective. "Limited-pay policies" and "interest-bearing obligations" will also have new rules. The proposed accounting rules are going through the exposure period now. Public hearings will be held late in June 1987. The proposal could be adopted later this year, effective for reporting periods ending after December 15, 1988, with early adoption encouraged.

Let's go through the three product categories that will have new rules.

First are Universal Life-type policies. A Universal Life-type policy has to have at least one of the following characteristics. It will have an account balance referred to in the contract to which premiums are credited, interest is credited, and charges are deducted for mortality and expenses. Surrender charges may also be applied. Other possible characteristics are charges or credits to the funds which are not fixed in the contract, or simply the characteristic of having flexible premiums. For example, a flexible premium deferred annuity would come under the accounting rules for Universal Life-type policies, which is why we have to say "Universal Life-type," instead of just Universal Life.

What will the accounting rules be? Reserves would be at least the gross account balance, which is the value before consideration of any surrender charges that would apply if the policy were lapsed. Some policies might require higher reserves if, in the actuary's judgment, the gross account balance was not a sufficient provision for future policy benefits. This situation might occur, for example, if you had deficient cost of insurance charges in later durations. It might also occur if you had endowment features which were not funded adequately by the accumulation of gross premiums.

Revenues would be the mortality and expense charges which are deducted from the account balance and investment income. The first of these two items is radically different from current accounting. Premiums are no longer revenues. Stop to think for a minute how your income statement is going to look if premiums are no longer in the income statement, but the charges that you deduct are. The growth that you have appreciated from the sale of universal life will no longer be apparent in the income statement. Many companies could show a decrease in premium income -- an increase in assets and an increase in liabilities, but possibly a decrease in premium income.

Expenses would be interest credited, mortality costs, and other maintenance costs. Increase in reserves would generally not be an item of expense. Deferrals are defined to be nonrecurring acquisition costs. I do not think it was the intent to really change the nature of the definition of deferrals from the definition in FAS 60. Because the term "nonrecurring acquisition costs" was used in the proposal, it has caused a little confusion, but probably would not imply that you would change your deferral practice.

Front-end loads would be used to offset deferrals. The net amount would be deferred. It might not be quite so simple to defer the net amount if, for example, acquisition costs occur at time of issue, but the excess first year expense charges occur month-to-month over the first policy year. You may have to be careful on the timing.

Back-end loads or surrender charges would amortize deferred acquisition costs (DAC) dollar-for-dollar. The intent is that when a surrender charge is realized, that much DAC would be amortized. The remainder of the DAC would be amortized ratably based on anticipated gross profits. Gross profit is defined as the difference between investment income earned and credited, plus the difference between mortality charges deducted and death benefits paid, plus the difference between expense charges deducted and expenses incurred.

A big difference for many companies is that the cost of internal replacement would not be deferred. Companies that have gone through replacement programs and have been recapitalizing their costs, could no longer do that.

The DAC amortization schedule for that portion that is charged to future profits will be done without interest. If you have done any of these calculations, I think you perceive the real motivation for excluding interest. Particularly with heavily back-end loaded products, the inclusion of interest in the calculation of DAC can cause negative amortization. The FASB really did not like negative amortization and developed a theoretical basis for excluding interest. There would be no provision for adverse deviation because there is a different accounting theory behind the valuation concepts of the proposed rules. Under this theory, provisions for adverse deviation are not appropriate. There would be a cumulative adjustment for changes in estimated profits. For example, let's say after two or three durations of a block of business in force, you change your view about what the prospective anticipated gross profits are. You may decide that you have over-amortized or under-amortized. If so, you would on a cumulative basis adjust the DAC up or down. That procedure is very different from what companies are currently doing for traditional policies.

"Limited-pay policies" have an easy definition. If the premium period is shorter than the benefit period, it is a limited-pay policy. The accounting for this type of policy would use FAS 60 type reserves, but defer the profit that was enjoyed under the premiums-as-revenues approach and recognize it in proportion to life insurance in force. This approach reminds me of credit life. The intent was not to allow front-ending of profits on single premium type products, but the words say that any limited pay product would come under these accounting rules. This would include, for example, 20 pay life sold in the traditional market. I hope this area will be clarified before the rules become final, because I do not think the intent was to cover the traditional kinds of limited pay policies.

"Interest-bearing obligations" such as guaranteed interest contracts are policies with no mortality or morbidity risks. They would be accounted for using methods comparable to interest-bearing obligations of other financial institutions. There is not a lot of explanation in the proposal as to how that accounting would be done. You may have to call the savings and loan or bank down the street to determine how to do that.

There is another provision in the proposed rules for treatment of realized gains and losses that a lot of actuaries have not focused on, which I will try to explain, using Exhibit 1. Under FAS 60, realized gains and losses are shown below operating income and net of federal income taxes. This treatment is shown in the first column of numbers in the chart. Under the proposed accounting rules, the belief is capital gains and losses are an integral part of operations. Therefore, realized gains and losses should not be shown after operating income, but should be included in operating income before the effect of income taxes. In this example, we simply added a line in income for realized capital gains, in this case $150,000 because it is pre-tax. As a result, on the federal income tax line we have a larger amount because it includes tax on realized capital gains. The proposed rules say that realized capital gains and losses should be shown in operating income, but it does not specifically say how they should be shown. This is one example. There might be a different way to handle it. You might, for example, simply include investment gains in net investment income, not showing it separately. That would be an approach that some would criticize because it does not allow the user of the financial report to determine how much of your operating income is a result of good experience with respect to insurance policies and how much of it is more or less discretionary income achieved by selling assets to realize gains.

EXHIBIT 1

REALIZED GAINS AND LOSSES

	FASB 60	FASB Exposure Draft
Revenues		
Premiums	$2,500,000	$2,500,000
Net investment income	850,000	850,000
Realized investment gains		150,000
	3,350,000	3,500,000
Benefits, claims, and expenses		
Benefits and claims	2,000,000	2,000,000
Acquisition & insurance expense	900,000	900,000
Administration expenses	100,000	100,000
	3,000,000	3,000,000
Operating income before income taxes	350,000	500,000
Federal income taxes	140,000	190,000
Operating income	210,000	
Net realized gains on investments, less federal income taxes of $50,000	100,000	
Net income	$ 310,000	$ 310,000

Let's talk about some of the rationale for the proposal. If you have not done so, you really should spend some time reading the proposal and some of the comment letters that have been issued. There is some good accounting theory on both sides of the issue. The debate on this proposal is really fascinating. The Board decided that general reconsideration of FAS 60 was not necessary at this time. I do not know if we should read anything into that statement or not. Let's just take it at its face value. The FASB believes what needs to be done is to determine a consistent basis for accounting for the new generation products.

FASB also believes that Universal Life represents significantly different risks and benefits because of what has been classified as the discretionary elements in the policy. Discretionary elements may be discretionary on the part of the policyholder or the company. For example, flexible premiums would be discretionary by the policyholder.

Cost of insurance charges are discretionary to some degree by the insurance company.

The proposal also reflects the belief that the fund value represents the amount policy by policy which is required to mature a policy.

Furthermore, provision for future benefits should not be made based on some kind of actuarial aggregation of all the policies, which theoretically is what we are doing with our GAAP factors with traditional business. So the idea of accounting for your liabilities on the aggregate basis is deemed to be inappropriate in a policy which has a separately identifiable fund which is to mature that policy. Therefore, the appropriate liability for that policy is the gross account balance.

Consistent with that concept is the belief that provisions for adverse deviation are not good accounting, according to FAS 5. Other industries generally do not have that kind of concept. While conservatism is certainly an attribute of most good accounting, the idea that you account for contingencies by simply making conservative estimates of your liabilities is not really consistent with GAAP. In most other industries, if the contingency is probable and reasonably estimable, you simply give it your best guess as to what that amount is, and that is the amount that you book. You do not generally make a provision for adverse deviation in accounting for contingencies.

One final theoretical point is the belief that premiums do not measure the attributes of the Universal Life-type contract because the contract is not premium driven. There is some good discussion of the rationale for that assertion.

Capitalized costs are treated the same as FAS 60, but the Board feels that amortization should be consistent with the accounting for performance under the contract. Under the retrospective deposit reserve standard that is used, earnings will emerge more or less as performance is achieved by the mortality charges covering death benefits, etc. Therefore, the amortization should be consistent with that concept.

DAC is not considered a monetary asset under this proposal. In accounting terms, this implies DAC is not an interest-earning asset. Therefore, DAC should not be made to appear like an interest-earning asset, and it should be accounted without an interest element in the calculation of the amortization schedule. We use interest on traditional business because DAC and benefit reserves are linked together. If you remember the early days of GAAP, there was a great debate over whether the benefit reserve and the DAC should in fact be separate, or whether the calculation of the net GAAP liability should generate a unitary reserve -- one factor representing the net of the provision for future benefits and the deferred acquisition costs. The decision was made that DAC should be shown separately on the balance sheet from benefit reserves. Now we have gone even further to stating that acquisition costs and benefit reserves are not really linked at all. This is a further basis for not including investment income in the calculation of DAC.

The statement is made by FASB that surrender charges are not representative of the earnings process and are not a source of profit. Rather, surrender charges are to recover acquisition costs, and therefore should be used to amortize DAC.

The FASB made an analogy between internal replacement costs and early extinguishment of debt. In my work as an actuary, I have very little exposure to early extinguishment of debt, but the general concept is there is not a continuing relationship. The transaction is made to establish a new relationship, and therefore the gains or losses on that transaction should occur in the current period.

As noted before, in view of the amount of trading companies currently do with their assets, FASB believes realized gains and losses are part of insurance company operations and should be recorded as such in the income statement.

How has the industry responded? The ACLI has written a comment letter in opposition to the proposal. The American Academy of Actuaries is also opposed. My employer, Ernst & Whinney, wrote a lengthy letter in opposition. Based on an informal survey, stock companies that I am aware of are strongly in opposition to the proposed accounting rules. Let's discuss some of the reasons why. First, since most of us work in traditional markets, few believe that Universal Life really has changed the risks and the benefits. There may be some companies that have entered new markets that are selling investment-oriented and tax-leveraged products, so that this is perhaps not a statement that can be made categorically. The majority of the business is being sold through traditional distribution systems to traditional markets for whole life insurance. It really does not represent different risks and benefits. If you accept that premise, the accounting should consider cost and funding over the long term in aggregate. Insurance companies are assuming risks in the aggregate, and the accounting should follow that principle.

One criticism, and this is one which I feel the strongest about, is that the two accounting models, the traditional life FAS 60 models versus the Universal Life model under the FASB rules, are too different by comparison to the difference between, say, an excess-interest life policy and a participating whole life policy. Finally, the rules do not provide a comprehensive accounting method for long duration products. The proposal has too much of a product-by-product orientation, and not a set of accounting rules based on a general set of principles.

There are more specific criticisms. One is that the change in definition of revenues is unnecessary and distortive. Certainly the use of the financial statement is going to be very confusing. Looking at the income statement of a company that has traditionally sold whole life insurance and now is selling a changing mix of whole life and universal life, imagine how the income statement is going to change from year to year. How would you possibly get a feel for the trends?

Another criticism of the FASB proposal is that DAC amortization practices are not appropriate with respect to surrender charges and the use of interest. For most companies who design their products with no front-end loads, surrender charges are really a source of profit. Since we have disputed the rejection of the aggregate method, we would feel that use of interest in the amortization of DAC is still appropriate.

The use of the limited-pay proposal for traditional products seems to be unintended and not really reasonable.

The guidance on interest-bearing obligations is not adequate. The paragraph about interest bearing obligations is too short.

The concept of premium deficiency is ambiguous. When you are not using the premiums-as-revenues approach in setting your liability, how can you define the premium deficiency? How would you do a loss recognition test? The effective date may not allow enough time. On the surface, the rules seem simple. If the gross account balance is the benefit reserve, how much simpler could it get? In fact, there is a lot of information that is required. For example, if you are the person preparing the income statement, you have to be able to make the adjustment going from statutory to GAAP to take out Universal Life premiums and put in cost of insurance charges. Many companies do not capture that information, and they are going to have to go back and reconstruct it. The time from this December to next December to reconstruct this information in order to restate earnings when they implement the new rules may be inadequate. It could be a very time consuming and tedious process.

How has the public responded? There are a couple of examples. An article in *Forbes* magazine seemed to predict the death of Universal Life. It was a slightly scandalous article, but interesting to read to see how others viewed the proposal. It simply said insurance companies have been selling these "investments," and they should be accounted for as investments. An issue of *Best's Management Report* has an article by a Prudential-Bache investment officer who said there would be a cloud over insurance stocks because investors are not going to be able to interpret the earnings reports. The author was also specifically critical of the ability to manipulate earnings by taking realized gains or losses to get the trend in earnings that is desired and hiding it in the income statement in such a fashion that it would not be disclosed.

I am going to try to make a couple of bold predictions. These predictions are not really all that bold.

The first prediction is that the proposal will pass essentially in its current form. The two areas where there seems to be room for further discussion are in the use of surrender charges to amortize DAC, and the use of interest in the amortization schedule. But all the arguments that we have made have been made before. Since the industry, many companies, the ACLI and others have been really active in presenting their ideas to the FASB all along, nothing that we have said here and very little that is contained in the comment letters is new to the Board, so the rules probably will pass essentially as presented in the proposal.

As I make this second statement, keep in mind that I'm the guy who thought Gary Hart would be the next president of the United States. I think there is going to be a reemphasis on par whole life. The combination of the Universal Life accounting rules and interest rates staying in a relatively low environment are going to cause many companies to try to sell more participating whole life. Those companies that have never introduced an interest-sensitive product are cheering in the background, because all of a sudden they have another chance to be competitive in the marketplace.

Let's take a quick look at what could happen to a fairly generic, but front-end loaded Universal Life policy. Exhibit 2 illustrates how the earnings would emerge on a policy like this, assuming that experience is as expected. The chart compares the composite approach recommended by the AICPA and the retrospective deposit approach favored by many to the exposure draft proposal. Let's use the next to the last column to focus on the ratio of exposure draft income to income reported duration by duration on the composite approach.

EXHIBIT 2

EARNINGS IMPACT

	GAAP Pretax Income*			Ratio of Exposure Draft Income to:	
Year	Exposure Draft	Composite	Retrospective Deposit	Composite	Retrospective Deposit
1	$68	$129	$141	53%	48%
2	67	101	121	66	55
3	62	94	101	66	61
4	64	92	97	70	66
5	66	92	94	72	70
10	83	100	98	83	85
15	93	107	107	87	87
20	109	113	107	96	102

* Per Unit Issued, Reflecting Terminations
Primarily Front-End Loaded
Experience = Pricing Assumption

Income is about half as much the first year, never catching up until sometime after 20 years. In 20 years, I'm going to retire. It's just not fair. The guy I am training is going to get the benefits of all the earnings that I worked so hard to put on the books. It is going to have a dramatic effect on companies' income. It may well have a dramatic effect on the way companies design their policies. Mark Evans has done some analyses of this and he is going to make his presentation now.

MR. MARK D. EVANS: Jim has discussed some of the basic provisions of the FASB draft. I would like to discuss some sample calculations which I hope will provide some insight into the behavior of the FASB proposal.

Let's compare the earnings results under FASB of two similar Universal Life products (Exhibit 3.) The first is a front-loaded product, and the second is a back-loaded product. For both products, we have calculated standard GAAP profits as a level percent of premium using an assumed interest rate of about 9%. The present value of cash flows on both products is 6.2% of the present value of premiums. This corresponds to the GAAP profit as a percentage of premium. Exhibit 3 also shows how profits would emerge on these two products according to the provisions of FASB. For the front-loaded product, 38.4% of FASB margins were used for FASB amortization. For the back-loaded product, 12.8% of FASB margins were used for FASB amortization. FASB margins for amortization were lower on the back-loaded product because much of the DAC was amortized

EXHIBIT 3

	Front Loaded	Back Loaded
Present value of profits as a percent of present value of premiums	6.2%	6.2%
FASB Profit (% of Premium)		
Year 1	4.3	-3.2
2	5.1	-3.6
3	4.6	-2.8
4	5.4	1.5
5	5.1	3.2
10	3.8	11.4
15	10.2	27.2
20	24.8	46.6
25	47.5	72.1

by the surrender charges. In order to simplify analysis of these results, it was assumed that all acquisition costs were deferred.

The illustrations for both products are based on equivalent amounts of insurance and equal premiums per thousand. They use the same mortality assumptions and the same lapse assumptions. An amortization period of 25 years was assumed. For the two products the cash values, of course, emerge differently. Also, commissions and acquisition expenses under the two products are slightly different.

Under GAAP, the profits for the two products come out identical. Under the FASB approach, the profits emerge in a fairly erratic fashion and are quite a bit different between the two products. I feel there are two items to be quite concerned about. The first is simply the erratic emergence of profits under the FASB method. Second is the fact that two products with the same inherent profitability, which happen to have different structures as far as the buildup of fund values and surrender values, produce such different profit emergence patterns under the FASB proposal.

Next, let's compare the behavior of two similar hypothetical back-loaded universal life products (Exhibit 4). The first is simply the back-loaded product discussed earlier. The second has higher cost of insurance charges producing greater FASB mortality margins, and a higher rate of interest credited to the fund producing lower FASB interest margins. The effects of these two changes

EXHIBIT 4

	Original Backloaded	Modified Backloaded
Present value of profits divided by present value of premium		
Expected Lapse	6.2%	6.2%
80% x Lapse	7.7	7.5
120% x Lapse	4.4	4.6
Ultimate credited interest	6.25	7.53
Cost of insurance	About 60% of 80 CSO weighted for male/female distribution	80 CSO weighted for male/female distribution

have been balanced so that the modified back-loaded product produces the same present value of profit as the original back-loaded product. I then took both of these back-loaded plans and recalculated the profits, first assuming that lapses decreased by 20% of the lapse rate, then assuming that lapses increased by 20% of the lapse rate. I found that the effect upon both plans from lapses deviating from expected was nearly identical, yet the FASB profit produced by these two plans is significantly different.

The modified plan produces profits that are about 2% of premium greater than the original back-loaded plan in the first three years (Exhibit 5). You can see that on the original back-loaded plan, the profits start out at about -3% of premium per year, whereas on the modified back-loaded plan the profits are running 1% per year.

EXHIBIT 5

FASB Profit (% of premium)	Original Backloaded	Modified Backloaded
Year 1	-3.2%	-1.2%
2	-3.6	-1.8
3	-2.8	-0.7
4	1.5	1.1
5	3.2	2.6
10	11.4	11.4
15	27.2	25.5
20	46.6	39.4
25	72.1	58.0

So, what is going on here is we have two products with slightly different design. One has larger margins in the mortality charges, the other has larger margins in the interest spread. Shifting the margin from one source to another has not changed the economic profitability of these products, given actual experience is equal to expected. Furthermore, if actual lapses are significantly different from expected, the relative effect upon profitability on the two products is practically identical. One justification for some of the characteristics of FASB is that, profits emerge in such a way that the sources of risks inherent in the various kinds of product designs are reflected. This was the goal. However, it appears to have a probably unintended side effect. You can also have products with slightly different designs but with very similar sensitivities to deviations between actual and expected experience and yet produce significantly different profit emergence.

Are there any questions or comments concerning the examples or any statements I have made concerning this subject?

MR. DON FRITZ: Mark, you compared the adjustment of interest versus mortality. Have you done any testing regarding front-end load versus mortality load in earlier years, so that you have the same incidence of the loading?

MR. EVANS: I have not specifically made that comparison that you mention.

MR. FRITZ: I haven't done any testing, but intuitively the fact that you have to offset a first year load against deferrable expense, whereas you would not have to offset a larger first year mortality charge against that expense would produce a big difference.

MR. EVANS: I would agree with you. I think what you are saying is a very good example of an opportunity for manipulation under the FASB proposal.

MR. MILHOLLAND: The rules do say that if you build in too much margin in your cost of insurance charges you should treat that as an offset to expense. So FASB anticipated that some people would try to do that. We have already started debating in our office what the definition of "too much" would be. One of our actuaries feels that as soon as you hit 1980 CSO for a 1980 CSO product that is the upper bound. I haven't agreed with him yet. The situation could be similar to the tax laws. There is such a focus on form here that there is going to be a lot of pushing of the boundaries.

MR. FRITZ: The other thing that occurred to me with that comment was you are going to get more interest margin at a later duration than earlier, but that is not true with mortality margins the way a lot of products are designed these days.

MR. PETER J. BONDY: I want to make a couple of comments because we have quite a bit of discussion on this topic at my company. To set the stage we have filed a written reply to FASB, and we intend to make a verbal reply. We felt that a lot of the story on the proposal was on the example in the back. I notice that the example was really not addressed in the presentation, so I'll make some comments on it.

First, the example indicated that you must split your DAC into surrender charge related and regular amortization. It further goes on to imply that you must evaluate your DAC annually. If you are going to evaluate it annually and follow the example, you are going to have to unlock your assumptions annually in order to reproject your margins and determine the new percentage rate of amortization each year. I think people should give some thought to that. I have a crazy idea that perhaps you can still get comments to FASB through your auditors if they plan to make a verbal presentation. The hearings are June 22 and 23, 1987.

The other point is with respect to surrender charges on back-end loaded products. We obviously sell them. You have to reduce DAC one-for-one by surrender charges realized. We have discovered situations where the surrender charge income for a specific policy would exceed the DAC on that one policy. We have a problem with that thinking in terms of depreciation accounting. For furniture, if you are selling a piece of equipment that has been depreciated, and you realize more, you take a gain. With this concept, we have to apply that gain for the good of the remaining policies. We have problems with that inconsistency. This problem has been discussed quite a bit in terms of product design.

With respect to par whole life, the issue I have with that prediction is it leaves the mutuals that are not required to report on a GAAP basis to sell Universal Life on a back-end loaded basis. We have a problem philosophically as to whether accounting policy should really provide for that competitive advantage to a group of companies as compared to another group of companies. I would like to encourage everybody to look at this more closely and, at least through the back door, give more comments on it to FASB. We are hopeful that they will make some modifications. We are not against retrospective deposit. We did test surrender charge incorporation in the amortization schedule. We found that if that were allowed, things would be okay. We think that there are other ways that they could handle the problems.

OPEN FORUM

MR. MILHOLLAND: Thanks Peter, those were excellent comments.

MR. EVANS: In the analysis we did, we assumed that the accounting related to the surrender charges, etc., would have to be at least issue year distinct.

MR. MILHOLLAND: Have any of you actually quantified the effect on your income statements? Have any of you recalculated 1986 income? Have you tried to implement the FASB approach to see what the effect was? Have many of you received a request from the SEC asking what the effect was? Have you responded to them yet? I do not think many companies have. We are working on one restatement.

MR. RICHARD S. ROBERTSON: Basically we have said that we do not know what the result is. It's too hard to measure. Based on some tests we have seen, we don't believe it to be material. We gratuitously suggest that it is not appropriate to comment on proposed accounting standards until they progress to at least the accepted stage.

MR. EVANS: We have done some work. I am sure that for some companies it is going to be quite material. Perhaps the internal replacement provision may actually account for the bulk of it.

FROM THE FLOOR: We are in the process of determining the effect on the income statement. Is it true that the change in reserves is not reflected in the revised income statement?

MR. MILHOLLAND: That is true. Premiums are recorded as deposits, so therefore there is no need for an increase in reserves. One question that arises however, is what if you have policies in which the gross account balance is not an adequate reserve? What do you do with the additional reserve? How do you get it into the liability account? So there might be small reserve increases, but generally there is no increase in reserves in the income statement.

MR. EVANS: Jim mentioned loss recognition earlier. As I understand it from some conversations with FASB, loss recognition would still be done for Universal Life much the way it is done for traditional products today. At first glance, it may seem that loss recognition tests, and the results from the FASB method would be quite a bit apart. But actually what happens is the way investment income is calculated for the purpose of calculating the investment margin under the FASB approach, if the product is in fact facing a loss recognition situation, there is a good probability that investment margin will never develop and will remain negative throughout the amortization period. So there is a good chance that if you have a loss recognition problem, then the FASB will reflect it in the investment margin calculation.

MR. RICHARD M. WENNER: I have some general thoughts on capital gains treatment. I noticed in your example you still had GAAP equity increasing because of the capital gains. It came through to the bottom line, in other words. Very often these capital gains are not really economic gains -- they are the results of swapping bonds perhaps, where you are trading capital gains for lower income in the future. Think of guaranteed interest contracts as an example. It is clear where the guarantees are. Also, bring into the picture the valuation actuary work that is going on. I think it is clear that the reserves are going to have to be raised because of the fact that you need more assets because they are earning lower interest rates. If you think of the example of a bond swap where you sell a bond and buy it right back again, you should have absolutely no effect on the bottom line. The reserve actuary in setting the reserves would say, "I need more of those low yield assets, in fact, I need just as much as the capital gain amounted to, and therefore, there would be no effect on the bottom line." I am significantly less familiar with Universal Life, but I think there may be some parallels there. I think the idea that the account balance is automatically the right reserve might be a hasty conclusion. In this case of the bond swap, I don't see how your GAAP statement is appropriate if you simply use the account balance and let the capital gain fall to the bottom line.

MR. MILHOLLAND: I think you have raised a very good issue. It's at least theoretically possible for you to take enough capital gains and drop your yield to a point where, if you were to do a gross premium valuation, you would have loss recognition. I think that is an issue that is emerging as you pointed out, particularly with GICs, and it is going to have to be addressed separately. It is not addressed in this proposal. It really applies to your traditional business as well, when you think about it.

MR. EVANS: To complicate your question, some realized gains are the result of trades made that are reflective of perceived inconsistencies in the market, where the investment department feels that the trade is made in such a way that the income of the company truly is enhanced. So you may even get into a sticky problem of what part of the realized gains is reflective of that legitimate long-term enhancement and which part of it needs to be used to offset lower yields on investments in the future.

Your comment on the account value is a pretty good one, because if one was to sit down and project out a Universal Life policy and calculate a benefit reserve using a level premium approach, you would get an answer different from the account values, so there are some issues there. As a matter of fact, it was mentioned earlier that the FASB had backed off allocating interest to accrue on the DAC because it sometimes caused negative amortization. Well, not reflecting interest on the DAC fixed the problem, but that was not the cause of the problem. The cause of the problem was the fact that the benefit reserve was set equal to the account value. Depending on what method you use for using GAAP for universal life, that will generate in certain instances negative amortization, not because you are crediting interest, but because you used the account value as a proxy for your benefit reserve. In just about every case, the account balance is different from what you would get if you went ahead and calculated your benefit reserve via some sort of projection method.

MR. WAYNE UPTON*: I want to respond to a statement the one gentleman made suggesting that you might best reach the attention of the FASB through your auditors. Nothing could be further from the truth. We have already heard from your auditors, at least six of them. Very little additional input from their clients through the auditors is going to be particularly meaningful. Additional input from you, as individuals or as companies, would be helpful. The FASB always accepts comments throughout the duration of a project, so if you feel a burning desire to tell us what idiots we are, or alternatively, to offer some suggestions as to how we could cure our problems or what you perceive them to be, please write us. But do so as individuals for your companies.

* Mr. Upton, not a member of the Society, is a Project Manager for the Financial Accounting Standards Board in Stamford, Connecticut.

MR. EVANS: Wayne, let me ask you a question. I don't want to put you on the spot here.

MR. UPTON: Oh, that's nothing new!

MR. EVANS: We do have perceived problems and some examples of these have been in front of you, or in front of the FASB for a while. Will we get answers or continued dialogue on these problems?

MR. UPTON: Certainly, and I would personally, at this point like to thank Mark for the work he has done. Many of the examples that you have seen today, he has been running past me in a much more voluminous format over the past couple of months. They have provoked us to some additional research. I don't know if I agree with him, but he has made me think a little.

MR. BONDY: I need to define the reference with which I made my comments. First, I assumed that the period for comments was closed except for those who were going to make oral comments. Given that fact, I did not feel that it would be appropriate for a company to make comments for other companies, as much as it would be appropriate for an auditor, if they were going to bring in verbal comments, to bring in additional comments from the clients. That is where I was coming from.

MR. PAUL J. OVERBERG: Jim, I agree with your conclusions, but I would like to slightly modify them. I'm referring to your conclusion that it looks like the proposal is going to be accepted and that many stock companies will start issuing participating whole life instead of Universal Life. My comments have to do with that latter part. I think it is possible that if you put your bright product development actuaries to work, you can develop a par whole life policy that to the customer will be almost identical to today's existing Universal Life policies. I don't think that is very hard to do. From all respects to FASB and the accounting world, it would be a participating whole life policy, and by so doing this, you could continue to operate under FAS 60. Furthermore, if your sharp product development actuaries get such a product developed in the very near future, and perhaps even file it with your local state insurance commissioner, you might tell the financial trade presses, as well as the FASB about it. Once everybody realized that the new FASB proposal can be circumvented, then maybe there will be a different answer.

MR. MILHOLLAND: That is an interesting idea. I really do not know how to respond to it. I appreciate your attentiveness and your input.