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**GAAP RECOVERABILITY ISSUES FOR
INTEREST-SENSITIVE PRODUCTS**

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- o Critical items in recoverability analysis
 - Expense inflation
 - Interest crediting strategy
 - Premium payment patterns
 - Indeterminate loads and/or cost of insurance rates
 - Lapse rates under varying interest rate scenarios
 - Assets(?)
- o How does recoverability work under FAS 97 GAAP?

MR. IAN M. CHARLTON: John Glass will be our first speaker, and he will be followed by Bill Morrow and Bob Crompton. John has been close to the development of Financial Accounting Standard #97 (FAS 97) and will devote the major part of his remarks to the effects of FAS 97 on recoverability and loss recognition issues. Bill will follow with the discussion of interest crediting strategy, ways and means of maintaining the planned interest spread, and the effects of the various strategies on lapse experience, and the ultimate effect on recoverability of the deferred acquisition costs. Finally, Bob will discuss premium deficiency testing and the modification of interest, mortality and expense margins to satisfy the question of loss recognition, or lack of the ability to recover the remaining deferred asset. We will then expand on these discussions.

MR. JOHN T. GLASS: FAS 97 involves itself with three classes of long duration contracts: investment contracts, limited pay contracts, and Universal Life type contracts. This topic focuses very much on Universal Life type contracts, which are defined in paragraph 10 on page 3 of FAS 97. It's worth just a minute to review the Financial Accounting Standards Board (FASB) definition of Universal Life type contracts. The FASB says that Universal Life type contracts are long duration contracts providing either death or annuity benefits which are characterized by any one of three features: (1) one or more amounts assessed by the company against the policyholder are not fixed and guaranteed by the terms of the contract; (2) amounts that accrue to the benefit of the policyholder are not fixed and guaranteed by the terms of the contract; (3) premiums may be varied by the policyholder within contract limits and without the consent of the insurer. So the test of having a Universal Life type contract is whether or not your long duration life insurance or annuity policy meets any one of those three conditions.

Let's review what we know about loss recognition under FAS 60. What is loss recognition focused on in terms of the accounting that we're used to? We

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actuaries would say it focuses on the adequacy of the Generally Accepted Accounting Principles (GAAP) unitary reserve. A GAAP unitary reserve is very simply the difference between a GAAP benefits reserve and the deferred policy acquisition cost. Another deductive item would be any deferred and uncollected premiums, if there were such a thing for Universal Life type contracts. So when we talk about loss recognition, we focus on that, and we ask the usual questions about adequacy of reserves. "Does this fund, this amount which I have on hand, along with what I'm going to get, provide me a sufficient amount to pay out what I need to pay out?" As we bridge over from FAS 60 to FAS 97, we're in a different world. There is a real gap there. For one thing, under FAS 97, there are no margins for adverse deviation in any of the calculations, and secondly, there's no GAAP benefit calculation in the traditional sense.

Now I'd like to call your attention to just what's in FAS 97. What is the GAAP benefit reserve in the eyes of the top accounting group in the United States for Universal Life type contracts? It has four pieces. First of all Item 1 is the accumulated value, the balance that accrues to the benefit of policyholders at the date of the financial statements. What is that? Well that's an aggregate number out of your operating system which basically is involved in the calculation of the net amount at risk and in the calculation of the interest that accrues to the policyholders.

Secondly, this GAAP benefit reserve is supposed to contain any unearned revenues. Any amounts that you've collected from the policyholder that you haven't earned in the current accounting period. So if you've assessed the policyholder some amount of money to compensate the insurer for services to be performed later, you have to set that up as a liability as part of this GAAP benefit reserve calculation. And by the same token, any amounts that you've previously assessed against policyholders, that are refundable on termination of the contract, have to be included. That's the third item. And item 4 is of particular interest -- any probable loss (premium deficiency as described in paragraphs 35 to 37 of FAS Statement 60) has to be a part of this GAAP benefit reserve.

So there you have it. Prior to the time that you determine that you have a loss recognition problem or a premium deficiency problem, you can visualize your GAAP Benefit Reserve as having the first three parts to it, but you may have to add something to that if you determine that you're in a loss recognition situation. Such a GAAP Benefit Reserve represents policyholder amounts in the eyes of the FASB, with no margins for adverse deviation involved in any way in the calculation. When we look at a unitary GAAP reserve in the context of FAS 97, we still have a GAAP benefits reserve, which is stipulated, minus a Deferred Policy Acquisition Cost (DPAC), equaling a unitary GAAP reserve; but our attention tends to focus very much on DPAC itself from a loss recognition point of view.

So let's discuss those costs which are capitalizable under FAS 97. In FAS 97 they took a backwards approach. Instead of telling us what is capitalizable and amortizable, the FASB told us what is not capitalizable and amortizable. This is described in paragraph 24 on page 7 of FAS 97. Let me highlight this for you. "This Statement" it says, "does not define the costs to be included in acquisition costs but does describe those that are not eligible to be capitalized under this Statement." And I know what you are thinking. You are thinking that the FASB will say "Do not capitalize any costs that are matched against the revenue stream as defined under FAS 97, or matched against the gross profit stream as defined under FAS 97." Wrong! Here's what they say: "Acquisition costs that

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vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred." That is not exactly what we would have expected them to say, but on the other hand it does handle items covered by premium loads which none of us were supposed to be capitalizing anyway.

Now, having looked at this, what we probably can say is that there is fundamentally no change in the costs that can be capitalized under FAS 97 vis-a-vis FAS 60. That's quite a relief, I guess, because we don't need to learn anything new, and we have methods in place to determine these kinds of costs.

We all know what's capitalizable and amortizable under FAS 60. What are those items? Basically *nonlevel commissions and expenses incurred by the company in putting the business on the books which are recoverable out of future revenues.* A very simple definition: If it's a variable type cost directly incurred in putting the business on the books and it's recoverable out of future revenues, you can capitalize and then amortize it. Many companies break their acquisition asset down into several components. In my company, we have expense assets 1 and 2. Expense Asset 1 represents basically selling costs, mostly things like commissions, the cost of paying commissions, Federal Insurance Contributions Act (FICA) tax on agents' commissions, etc. Our Expense Asset 2 consists of the variable portion of selection and issue costs. Other companies may have some variations of those, but those are the old standbys that have been around since 1972, when the audit guide came out.

There's another aspect about Universal Life type contracts that poses an interesting question. What do you do with the same kinds of nonlevel commissions and expenses on changes in coverage that take place on a post issue basis? Such changes in coverage come from two sources, the producer and the policyholder, and are not terribly predictive in determining the present value of future profits on a book of business.

We've discussed the costs which are capitalizable under FAS 97, and we've said they're essentially the same old thing. But it is the manner in which these costs are to be amortized which, of course, impacts on the question of recoverability at some given point in time. This is where the work begins because the innards of the FASB method take some study to understand. And again, let's highlight those for you.

Essentially the accountants direct us to calculate an amortization ratio on a given block of business, and apply that as we go along. This amortization ratio is defined as the present value of the capitalizable acquisition costs divided by the present value of the future gross profits as defined under FAS 97. Those gross profits include a gross interest margin, a gross mortality margin, a gross expense margin, and any surrender charges that you anticipate collecting. That ratio is to be determined based upon realistic assumptions without any margins for adverse deviation. Probably one of the key things about it is that it is to be regularly evaluated. The regular evaluation is supposed to let you ascertain whether your ratio is, in fact, appropriate. Significant events that take place in the life of your book of business may cause you to unlock the amortization ratio because of having a material effect on the present value of the future profits at issue.

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We have found that the area of unlocking is where most of the basic accounting issues arise as we begin converting to FAS 97.

Under this dynamic amortization we really have loss recognition as we go, because probably no great length of time is going to go by before we reevaluate. Some would also say that there are some opportunities for gain recognition as we go because of this dynamic method of amortization. If a company were to decide to use this method in what we would probably characterize as an inappropriate way, it could cause this method to function in the same way that a contingency reserve would function. And so there are abuses possible despite the FASB's attempt to eliminate subjectivity from the accounting method to be used on these contracts. (There is subjectivity in setting the assumptions utilized in the present value of the future profits. The results of applying FAS 97 are ironic, I think, because of all the criticism that the FASB has leveled at the whole notion of having margins for adverse deviation in the first place. They don't like that, and they say it is too subjective and yet, they have given us a method where we can unlock as we go.)

Where are we? We've got a dynamic amortization method on Universal Life type contracts where, by and large, we have the right to change the cost of insurance rates and the interest crediting rates, and where in the accounting model premiums are not revenues; and yet, the FASB says the provisions of FAS 60 apply with respect to loss recognition. So now we are bridging back from FAS 97 to FAS 60, and if under the provisions of FAS 60 you do find that loss recognition is necessary, that amount is included as part of the GAAP benefit reserve under Universal Life type contracts.

So we are back to FAS 60 on loss recognition. All of you, I think, are familiar with the FAS 60 model. It's what we've been used to for a long time. Premiums are revenues under FAS 60. Loss recognition is then characterized as the same thing as premium deficiency and, under paragraphs 35 to 37 of statement 60, we look at a unitary GAAP Reserve (i.e., benefit reserves minus DPAC). Our benefit reserves would have been calculated with margins for adverse deviation, and when we made the present value of future premium calculation and the present value of the future benefit calculation to see whether this unitary GAAP Reserve was adequate, we would have been using margins for adverse deviation. And now we're in that world on these FAS 97 contracts, and I think it is an interesting question to say "Well, do I or do I not start bringing in the notion of margins for adverse deviation as I approach testing for loss recognition?" What does this mean?

It's been somewhat traditional in a loss recognition situation that with respect to the components of the unitary GAAP Reserve, we've always tended to adjust the DPAC first and then the GAAP benefit reserve. At least that part of the old process seems to hold up because DPAC is the big part of loss recognition on Universal Life type contracts.

Let me just mention one other thing that's been on my mind, and I think on the minds of other people who have studied this. We are in a situation in which the FASB has essentially divorced the asset side of the balance sheet from the liability side of the balance sheet. Initially they focused in very much on the liability side, and they have latched onto the accumulated value essentially as the appropriate liability. In that process they've sent us a signal which they've been sending all along, and that is that their conceptual framework is not the same now as it was. They have a balance sheet focus instead of an income

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statement focus and, further to that, essentially they are taking a policyholder point of view in their accounting pronouncements as opposed to a book of business or aggregate point of view. The very thing all of us have been trained in all these years is that predictability exists when the law of large numbers comes into play on a book of business of sufficient size. We are being forced to use an arbitrarily determined GAAP benefit reserve out of the framework than I've described. Some would ask what to do about DPAC to achieve a theoretically correct unitary GAAP Reserve. Do we try to do something as artificial with DPAC as the FASB done with the benefit reserve so that when the GAAP benefit reserve and DPAC are put together, the result is meaningful?

Well, if you did that, then when you approach the subject of loss recognition you have a further complicating factor which is that DPAC is artificial because it is an offset to another artificial number.

We're not supposed to be thinking that way. Yet, I think the FASB in many respects, under FAS 97, has not given us an accounting method which reflects the economics of the business or which permits us to show an accounting result consistent with the internal rate of return in the product. And so, we're going to have to work with the FASB method as best we can; and we want to remember that the purpose of GAAP accounting is to provide a meaningful disclosure about the economics of the business, about the company itself, and about the products that it offers.

MR. WILLIAM P. MORROW, JR.: The interest crediting strategy is a critical item in GAAP recoverability. The anticipated income from the interest spread is a significant part of the total income expected for most interest-sensitive products. Consequently, it is important to evaluate the probability of earning the spread when evaluating GAAP recoverability. So I would like to talk about the interest crediting strategy and how it is involved in making these recoverability tests.

The goal, of course, is to earn the sum of the interest spread, credited rate and investment expenses over the life of the contract. However, since interest-sensitive products have only been issued by most of us for four or five years, most of the investment income anticipated in the product at issue is yet to be earned since we are so early in the life cycle of the products. Consequently, the majority of the investment income that must be anticipated or assumed in your tests must still be based on assumptions in the future.

I would like to talk about where we are now, the desirability of a well-defined strategy and some ways of evaluating recoverability as it relates to the investment income part of the contract. Where are we now? When you analyze the rates being credited today, there are numerous strategies being employed. Due to competitive pressures, companies have been slower to lower the credited rates, as the earned rates have decreased. Companies crediting a portfolio rate are often relying on the higher rates of the past investments to support current rates.

For example, since the first quarter of 1986, the credited rates on one of my company's products has decreased from 10% to 9%, a reduction of 100 basis points. During this same period, the yield for the assets supporting this product has decreased 225 basis points. And this is an asset account where we are purchasing only investment grade assets. I suspect this is typical of many companies. The recent increase in rates gives some relief, but I suspect some

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companies are not earning rates large enough to support their credited rates. So what have many companies done?

Some have gone farther out on the risk curve in their investments. Sometimes, these are called below investment grade securities, or more commonly, junk bonds. These securities provide higher returns, due to the lower quality of the issuers' underlying assets. The question of whether to invest at all in junk bonds is a controversial one. Some critics assert that the industry needs to hang tough and reduce the credited rates rather than invest in more riskier securities. Insurance companies now own over one-third of the junk assets in the United States.

Now I would like to talk about the various ways that interest rates are credited. Maybe one way to divide it up is between the portfolio and new money approach. Some companies use the portfolio approach which means that the same rate is applied to a given product, regardless of the time of issue. Other companies are using the new money approach which allows some flexibility in crediting different rates for different policies. The use of an investment year method allows even more flexibility in crediting rates.

An analysis of 546 flexible premium products in the April Tillinghast Universal Life Analytic Study (TULAS) report (which is published by Tillinghast, a report showing the interest rates and characteristics of this number of products), shows that 25% of these companies are using the new money approach. Fifty percent use the portfolio method, and the other 25% did not specify either of the two methods.

According to the TULAS report, the mean credited rate in May for Universal Life was equal to 8.75%. However, rates range from a low of 6% to a high of 11%. The majority of the rates range from 8 to 9.5%, a difference of 150 basis points which is really the spread in a lot of products; 35% are crediting 8.5% or less, 25% are crediting 8.51% to 8.99%, while 40% are crediting 9% or higher.

I would like to explore this a little bit more in terms of recoverability and try to talk about the various strategies that result in this range of credited rates, and talk about the risks that I believe should be included in the test for recoverability.

First let's look at the 35% crediting 8.5% or less. I am going to assume that this group by and large is earning their interest spread. That's great. They're earning their spread so maybe the question is whether they can control their lapses while crediting a below average rate?

It is difficult to tell about the 25% crediting 8.75%. Now I'd like to talk about those crediting 9% or greater which is really 40% of the companies in this report that I referred to earlier.

I'm going to divide these companies up into four different categories and talk about a strategy they may be using and what the risk would be as far as recoverability goes.

First, let's consider those investing going farther out on the risk curve in investments. The recoverability concern here is whether an appropriate charge is being made for the credit risk. When you do the recoverability, I think it's important to make an appropriate charge for this risk. However, that's not an

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easy number to come by. Since the percent of junk assets as a percent of total assets is unprecedented, it is difficult to predict the risk that insurance companies may be taking. Most of the statistics available on default risk are for a different form of asset than many of the junk assets issued today -- which are in many cases assets representing the future earnings of the company. However, if a recession causes these junk assets to default, some insurance companies may be in financial trouble. Because of this risk, certain states, New York for example, now have laws regulating the percentage of these kinds of investments that can be held in a portfolio.

Now let's look at another strategy. Some companies are crediting more than they can justify in order to gain market share. The theory here is while assets are small in the earlier years of the contract, the extra cost of not earning the spread is small and later on they will begin crediting what they actually earn. Sooner or later, this strategy has to change. The recoverability risk here is the ability to change the strategy in midstream of the policy without incurring higher lapses. And I guess in all these cases, when we talk about lapses we're also talking about keeping your field force and your marketing organization happy with that change in strategy.

Now let's look at a third category. Some companies are crediting more than they can justify now in hopes of switching to a new money or an investment year approach in the future at which time they will bring credited rates and earned rates more in line. Again, it is difficult to predict the probability of making this strategy work in the mid-stream of a policy.

Now let's go to the fourth category. Some companies do not know whether or not they are earning their spread; and this group can probably sleep better at night than any of the others.

Interwoven in all of the above is the hope that interest rates will rise and fall in such a way that the spread can be earned by the time the life cycle of the policy is complete.

One common characteristic of all of these methods is the fact that a lot of difficult assumptions for the future must be made in order to be realistic about the anticipated spread that will be earned throughout the life of the policy.

Now I would like to talk a little bit about recoverability analysis. First, I think it's important that one have a strategy in the company and that this strategy is defined, or else it's difficult to know how to predict the interest rates or spreads in your testing. In preparation for this presentation, I looked up the word "strategy" in the dictionary. Strategy is defined as "the art of devising plans toward a goal." The plan for earning the investment income and crediting the interest represent the overall investment strategy of the company. It is desirable for the company to have an investment strategy in writing. If your company does not have a written investment strategy, I would encourage you to complete one. The process of developing a written plan will be very helpful in getting all of the interested parties together in a common understanding of the company's goals in regard to investment strategy.

Now I would like to talk about some ways of evaluating the recoverability in regard to interest. The first step in a recoverability analysis is to define the rate of interest actually earned and anticipated in the future.

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I would like to talk about defining the rate which may be credited from the earned rate, and I would like to call this the "earned credited rate." At first, it seems like a simple exercise, hardly worth talking about. You simply subtract the spread from the going investment rate at the time. But if you really think about it and dig into it, it's really more complicated than this.

I'm going to define the "earned credited rate" as equal to the rate earned from the portfolio supporting the products, less investment expenses (unless they are provided for elsewhere in the product), less a contingency charge for a default risk, less the required spread, with all of the above adjusted for Federal taxes.

In order to get an accurate rate earned from the portfolio, the assets must be segmented by major product line. Also assets may be segregated by new money, old money, investment year, and so forth if you are crediting rates that way. This is only one good reason for segregating the assets by product line as assets must be segregated in order to properly match the asset needs with the liability needs. In calculating the earned rate, you have to decide what you will do with capital gains and losses, both realized and unrealized. Are they to be included in the calculation or not?

A reasonable allowance for investment expenses should be deducted from the gross interest rate unless expenses are provided for elsewhere in the product.

An appropriate provision should also be made for default risk. I think it is important to make this deduction, particularly if the company is going higher on the risk curve. In my company, we plan to accumulate this deduction and keep it in a memorandum reserve account. This memorandum reserve account will be used to offset credit risk losses that may occur in the future in the given portfolio.

Also if corporate dividends or tax exempt investment income are included in the portfolio, marginal tax rates should be applied to both income and outgo in determining the earned credited rate. Corporate dividends and tax exempt income have the effect of reducing taxes on income as well as reducing the tax credit for the interest credited to the policyholder. So unless you use marginal tax rates, if you have these kinds of investments, it's really difficult to tell where you stand on an after tax basis if you have tax exempt products or corporate dividends.

Now just a little bit about tools for evaluating GAAP Recoverability. Perhaps the best method of evaluating all of this is to use the tools currently being developed for the valuation actuary. This involves cash flow scenario testing based on numerous assumptions relative to interest rates and lapse rates, in particular. The Interim Actuarial Standards Board now has an exposure draft out on "Recommendations Concerning Cash Flow Testing for Life Insurance Companies." However, for most of us, these tools are not available, and we must rely on less sophisticated approaches.

In the absence of the approaches just described, it may be possible to develop rules of thumb concerning the relationships of interest spreads, profits and lapse rates. For example, in my company for one of our products, a 1% spread translates into profits equal to 4% of the premium. If the spread is not expected to be made, then the impact on profits can be determined this way.

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Also in evaluating GAAP Recoverability of the interest crediting strategy, we must consider the impact that this strategy has on lapse rates. Formulas used in the valuation actuary concept correlates these lapse rates with interest rates. Again, it may be possible to develop a rule of thumb measure as to the impact of lapses on profits. But when you get beyond one variable, the rule of thumb method probably breaks down. It's good for one variable but the combination of two or more makes it difficult if not impossible. Of course, the test for recoverability must also be correlated with the assumptions for lapses as well as expenses because the rate of interest has some correlation with the rate of inflation; consequently, the rate of expenses that would be expected in the future in the product.

MR. ROBERT B. CROMPTON: Statement of FAS 97 represents a sharp departure from GAAP for life insurance that we've known in the past. In fact, I think there may be a tendency for some actuaries to view Statement 97 as the end of life as we know it. For interest-sensitive life insurance products, however, loss recognition and recoverability issues really are not going to change very significantly. What I am going to talk about first will be recoverability issues for investment contracts. Next, I'm going to talk about the use of the amortization model for Deferred Acquisition Cost (DAC) in loss recognition testing, and then I'm going to talk about the use of nonguaranteed elements such as interest credited and Cost of Insurance (COI) charges in avoiding any sort of loss recognition, and then finally, the catchall, miscellaneous topics.

Investment contracts, under the new statement, are those contracts which have no material amount of life contingencies, and they would include such contracts as Guaranteed Investment Contracts (GICs), deferred annuities, annuities certain and possibly annuities that are certain for a number of years and then for life thereafter as long as the portion that's for life is not material in relation to the amount that is for the certain period. Now let me contradict what I just said in the opening comments and that is loss recognition for these contracts may be different from what we've known under Statement 60. The reason for this is that investment contracts are to be treated as investment contracts for other financial institutions. Now other financial institutions do not have any sort of loss recognition required in their accounting; however, they don't have any DAC so we're in somewhat of a quandary. I think probably the most logical way to approach it is to say that since other financial institutions are required to set up a loss reserve, for any asset that has been impaired, what we could say is that loss recognition for investment contracts would mean that we would have to write down our asset, the DAC, but if loss recognition is greater than the amount of deferred asset, we would not set up a separate reserve for that. Any further loss would flow down to the bottom line as it occurs. That is, we would have no current recognition of future losses beyond the amortization of the DAC. So for these contracts, we do have a little bit of a change from Statement 60.

For Interest-Sensitive contracts, for Universal Life, Excess Interest Whole Life, loss recognition is going to be the same thing that we've always had in the past. We're looking at the present value of future income, the present value of future outgo, and the DAC balance. So nothing has really changed here; however, now that we have to develop margins for interest, for expenses, for lapses, there may be some sort of a desire to make the DAC amortization schedule do double duty and use it for loss recognition testing as well. This is one thing that is a possibility; however, we have to be careful when we do this. There are certain changes or items that we need to take into account when we do this.

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First of all, the present value of future margins specified under Statement 97 used to amortize DAC is based on the credited rate rather than the earned interest rate. So if we are going to use our DAC model to do loss recognition testing, the first change we need to institute is to replace the credited interest rate with the earned interest rate and this does not seem like it's going to be too big of an item.

In addition, if after making these changes, our model shows us that we have some losses on some of our sales, we do not necessarily have loss recognition yet. As in the past, loss recognition is generally considered on a line of business basis; that is if we have some of our DAC cells showing that we've got a loss we can aggregate those up to a higher level unless of course we've done really aggressive modeling in our DAC schedules so that we've got a DAC schedule for a line of business.

Another item to consider, if we are using this amortization model for our loss recognition testing, is expense allocation. The expenses that go into the amortization of DAC are the direct expenses and the indirect expenses. True overhead is excluded. One thing we might consider is, if we have a loss recognition problem, "Is all of the indirect expense that we have in our DAC model necessary to support the business on an ongoing basis?" Typically, this will not be a large item under Statement 97, at least it does not appear that that will be the case. If there are future losses on a line of business, one thing that has been mentioned already and I'll be touching on this again, is "What adjustments can we make for credited interest, for mortality charges?"

Bill has already alluded to the fact that one thing we really need before we can make a good judgment on this is a strategy and not only an interest crediting strategy, but a thorough understanding of what the product is all about. How is the product in total managed? We can ask ourselves such questions as: "What is our market? How is it being produced? What is our expected response to competition, not only from other insurance companies, but from noninsurance companies?"

In a sense, nonguaranteed items on interest sensitive products put us in the same situation as issuers of guaranteed renewable A&H products. As you know, guaranteed renewable A&H products have the ability to increase their premiums; however, in some cases, the ability to increase the premiums is only of dubious value in avoiding future losses, because any future premium increase could result in spiraling anti-selection where all the healthy policyholders leave until I guess if you take it to the extreme case, you've got one policyholder left and you're charging him premiums exactly equal to the amount of his medical expenses plus any sort of overhead that you need to administer the policy. So we have to be very careful when we take these into account -- that is, we need to make our other assumptions besides mortality charges and interest credits consistent with the assumptions that we are assuming for the nonguaranteed elements.

For instance, if we decide that we are going to avoid loss recognition through crediting a lower interest rate, it's probably not reasonable to assume that lapse rates are going to be unaffected. Similarly, if we decide that we could avoid loss recognition through a change in COI, we've probably got a little bit more maneuverability here as far as the assumptions that we make with respect to lapse because COI is not an item that's quite as visible as the credited interest rate.

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Typically though, mortality margins and expense margins become relatively less important as duration increases. Therefore, if we're out several durations we may not have the ability to avoid loss recognition through changing COI charges. However, if the problem has been that we have had insufficient premiums, we've had large premium lapses since day one or nearly day one so that our accumulation amounts or fund values have not reached the point that we assumed they would, it may be that an adjustment of COI will allow us to avoid loss recognition in this situation. Whatever the case, we need to be careful that the assumptions for lapses are appropriate and consistent with any changes in interest credits and any changes in mortality charges. Also, we need to make sure that these changes in nonguaranteed items are going to be consistent with our philosophy for a particular product line and that would go back to our review of the strategy behind the product.

When we do have loss recognition for a product, let's talk about the mechanics of how that's going to work. When we have loss recognition, we're also going to be in the situation where we have to restate the amortization schedule because we will have a significant change in our margins.

Now a company may want to state their change in DAC in two pieces -- that is, what is the change due to the unlocking from the change in the amortization schedule itself, and how much is due to a change in pure write-down of DAC because of recoverability issues? Now let's take a simple example. Let's say a company had an original amount of deferred expenses of a million dollars and several years out their DAC balance is \$800,000, but their recoverability testing indicates that only \$600,000 of that is recoverable. Perhaps the easiest way to back into this information is to recalculate the schedule and then back into the original amount that would need to be deferred to give us \$600,000 at the current date. In this way, we will be able to split the DAC change into the two pieces in which we are interested.

Another item, and this again is an item that we've had since FAS 60 days, is amortization periods that are shorter than the life of the contracts. Essentially what we're doing is we are ignoring future margins past the end of the amortization period. For loss recognition testing, we need to, of course, take these future margins into account and, of course, that's no change from before.

Let me mention one thing in relation to bonus benefits. If we have a contract that has benefits that would include such things as refund of mortality charges after so many years or any sort of interest bonus or any other type of benefit that's not provided for within the fund value, we do need to accrue a separate reserve for these benefits; otherwise we have to consider that our reserves are not sufficient, and we are in a deficiency situation.

One item I think that has developed a series of questions is the fact that we no longer have lock-in under FAS 97. Does lock-in no longer apply to recoverability and loss recognition? In other words, say we have a recoverability situation in which we write off a certain amount of our DAC and then a few years later we determine that things have changed again so that the product is again profitable, is it possible to go back and recapture the unamortized portion of the DAC that we wrote off in the past? We've actually had to set up an additional loss reserve for premium deficiencies, and our profitability tests indicate that we have returned again to the point of profitability where we don't need that loss reserve; can we write that down? The statement does not specifically address this point; however, it appears that this will not be allowed under

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FAS 97. The point of FAS 97 seems to be that we're going to have fund balance as our reserve and all this unlocking is just a means of amortizing our DAC so that we would not be allowed to go back and recapture any sort of DAC that we had written off nor would we be able to reduce any sort of loss recognition reserve from the fact that our profitability has increased.

MR. CHARLTON: Although we are unable to provide for adverse deviations, I presume we will be able to make an assumption regarding inflation in expense factors. However, what tools are available to us to provide for inflation in the mortality assumption, due to AIDS for instance, without invoking a recoverability question?

MR. GLASS: I don't know that I have a hard and fast answer for that. We just observed what everyone else is observing about our industry -- which is that we are facing a potentially devastating situation with the AIDS epidemic. With all of the impacts that it has on all of our life and health businesses, here we are now with the new accounting standard where we probably will all use fairly long amortization periods. We will project out, predict, ascertain, the present value of the future profits over that period as we always have, taking into account in any loss recognition situations the ability of the company to change its COI rates and to adjust its interest crediting rate. All of this in the light of having gone to, or being in the process of going to the 80 CSO Table, which for many contracts, governs the maximum COI charge which can be levied by the company against the policyholder.

AIDS is a very real situation. It does, I think, cause us to stop and think about the propriety of what we are doing. The FASB adopts the policyholder point of view on the liability side. And when it wants to, it adopts a book of business point of view which it has done for the purposes of amortizing DPAC. The illustration in FAS 97 shows a 50-year amortization period. I think we all need to stop and think about our ability to ascertain things over protracted periods of time given the uncertainty of what's going to happen in AIDS. The real issues involved with AIDS are far more important than this. They are whether we will survive or not. AIDS is certainly an aspect of our thinking on loss recognition. If anything, it would probably lead a lot of us to shorter amortization periods than we've been used to in the past, being more conservative than before.

FROM THE FLOOR: Just on the concept of no more lock-in, I'm not quite sure I understood you correctly. I was under the impression that if we write down the deferred acquisition costs due to poor experience, and then years later it turns around, we can actually take that asset back up. Is that incorrect?

MR. CROMPTON: What I was saying was that it appears that the purpose of the statement was to provide a change in the way that the asset would be amortized in the future and that although there is unlocking of assumptions to go into the amortization schedule, it does not look as though the intent of the Board was to allow a recapture of any DAC amount that had been written down because of recoverability testing.

MS. FAYE ALBERT: I wanted to ask Mr. Glass about calculating benefit reserves for a start-up business. Do you still anticipate that you would calculate these reserves as though locked-in assumptions were appropriate? It seems if you're setting up an asset you can't relieve an accumulated fund.

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MR. GLASS: Let me just say that the rules are the rules, and I think on the liability side of the house, the GAAP benefit reserve is very well defined, and the accumulated value is essentially it and that reflects all of the activity that the company has engaged in with a policyholder. And then you make adjustments to that which take into account real world activity. That's how you get your GAAP benefit reserve. There are no margins for adverse deviation any longer. There's no use at all of pricing parameters the way we've been used to. We used to start with pricing. We would put in margins for adverse deviation, which left a little bit of the gross premium for profit. There was a methodology on the liability side which was consistent with the methodology on the asset side. We've lost that now. There's no connection because the GAAP Benefit Reserve is defined.

There's not much to do on the benefit side because if you're in the Universal Life business and you're using any of the operating systems that are currently around, all that you really need to do is take the accumulated values from the operating system and adjust them to the end of the accounting period. Nearly all of the work under FAS 97 is on the asset side, and I dare say there's not a great decrease in total effort compared with FAS 60. Although you don't make a benefit reserve adjustment you have to do a lot of work with respect to the present value of future profits to set your amortization ratio.

As far as factor methods go, it's an interesting question as to how you will go about getting this done. Even though you don't need to do much on the benefit reserve side, how are you going to effect amortization on the asset side? There's one school of thought that says I'm going to do all this on a worksheet. Another school of thought says I'm going to do this using factors the way I've been used to.

We will break the book of business down by plan. There will probably be three or four age cells within each plan. We may also break it down by mode of premium payment so we can at least make a distinction between the annual and monthly/ABC business. Soon we have ourselves a large number of cells, and those cells are all set up by policy year. Now you're going to apply those factor-cells to an in-force calculated at the end of some calendar period of time. When you go through the process of reassessment periodically you're going to change your factors. When you add new products, the factors are going to proliferate even further. So for those reasons, I think, some would say to aggregate cells as much as possible. Others would say that the factor method is okay, it isn't any more complex than it ever was. So I think you need to choose. If you use a factor approach, you will, in effect, produce a DPAC at the end of a given accounting period, and you'll have one sitting there at the beginning of the accounting period. Now you know what the change is. How do you know whether the change in DPAC related to the gross profit margins makes any sense? You're going to have to go back and look at that. You have to be careful that you exercise the usual care and you've got to live with the rules, whether you like them or not.

MR. JOSEPH H. TAN: Most of the recoverability tests that are done are on a pretax basis. Sometimes, though, we see cases in which we just apply a straight marginal tax rate to the pretax results. I believe a more correct approach is to take into account deferred tax liability, and I believe that the results will look better if we take deferred tax liability into account. The reason why I say this is that deferred tax liability is a non-discounted item, but the assets that support it actually earn interest. For instance, for the company to appear solvent,

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at least on a GAAP balance sheet, it needs assets at least equal to the net GAAP Reserve and deferred tax liability, and we know that these assets earn interest. Could the panel comment on this or confirm it?

MR. MORROW: It sounds like a reasonable assumption to me. I guess one dilemma in doing taxes this way is if you have several lines of business, you may have to allocate the taxes to a line of business. Obviously you can do taxes a lot better in total.

MR. GLASS: I'd like to comment on that. Of course, deferred taxes should be discounted and perhaps FASB someday in its wisdom will permit that. I think the existence of FAS 96, which changes deferred tax methodology around, brings up the point that you want to be careful taking deferred taxes into account in recoverability testing because you can get changes of methodology on that item. Most of us who are making the change in accounting on FAS 96, I think, have realized that we've got to do FAS 97 first before we can do FAS 96. In addition, you want to be careful that you don't unduly take into account the flaw of not discounting and rely on that because loss recognition is a very serious kind of a thing. It is couched in terms of an accounting model. Does this GAAP Reserve plus these deferred taxes pass the test? But at the core of it all is whether or not the company, out of its cash flow, is going to be able to survive. And that's what you want to get at some way, and let the accounting model help you.

MR. MARK D. J. EVANS: I had a question for Bob Crompton. He mentioned a couple of adjustments he needed to make to the FASB model before recoverability testing could be done. The first one was the obvious one of using the earned rate to discount margins rather than the credited rate; but the second one lost me a little bit. Could you elaborate on that please?

MR. CROMPTON: The second adjustment was the substitution of the invested asset for the fund balance. In other words, rather than using an interest margin based on the fund balance, your interest margin is based on your net GAAP liability.

MR. EVANS: I believe what you're suggesting is double counting and you'll get an unduly conservative result since under the final FASB version you do have interest on the deferred acquisition cost. Let me put this in a slightly different way. If you use the earned rate in the FASB model to discount the margins and you come up with a FASB amortization percentage as a result of exactly 100%, if you then take that product and discount the cash flows that will be generated you'll get a present value of cash flows of exactly zero, suggesting that you are exactly right at the point of having a recoverability problem but that you do not, indeed, have one. You're right at the edge. From this process, I find myself questioning your statement that you need to make this adjustment in the asset.

MR. CROMPTON: Okay, now I find myself questioning it too. I'm not sure about that Mark.

MR. EVANS: I guess you might want to go back and do some calculations with that. I believe you will find a lot of validity to the point I'm trying to make here.

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MR. S. MICHAEL MCLAUGHLIN: I would like to thank the panelists for a commendable discussion of this complicated subject. However, I think some aspects of the subject were treated in separate discussions rather than all at once. What I had hoped to hear was an integrated discussion along the following lines. For loss recognition, gross profit from various sources (interest, mortality, loading) is projected forward using realistic assumptions, one of which is presumably the earned rate of interest. The period of projection is from the issue date for the lifetime of the contract. Deferrable expenses are also projected forward using the same assumptions. The present value of profits is then compared with the present value of deferrable expenses.

Let us assume that in this initial projection the present value of profits exceeds the present value of deferrable expenses, that is, acquisition costs are fully recoverable. Then the DAC from the amortization schedule is used without adjustment for loss recognition.

At the next financial reporting date, actual experience must be used instead of assumptions, to the extent that it has emerged. A new projection is made from issue for the lifetime of the contract. Since actual experience will differ somewhat from the original assumptions, the amortization pattern will differ, and the amount of unamortized DAC will also differ from that originally projected. The new unamortized DAC for the valuation date is to be used, provided there is no loss recognition.

To test this, the present value of gross profits and the present value of deferrable expenses must be compared. The comparison considers the entire projection period from issue for the lifetime of the contract. A combination of actual experience and future realistic assumptions is used. If the present value of gross profits is now less than the present value of deferrable expenses, a proportionate amount of deferrable expense must be written off. This is a permanent write-off. The DAC to be reported is the unamortized portion of the reduced deferrable expenses.

At the next financial report date, the same process is followed. If the most recent experience now indicates that the present value of gross profits exceeds the present value of deferrable expenses, nevertheless there has been a permanent write-off. The DAC to be reported is the unamortized portion as at the reporting date using the amortization schedule based on a combination of actual experience and future experience assumptions, calculated from the issue date for the lifetime of the contract.

Subsequently, if experience should deteriorate to the point where all DAC is eliminated, a revenue deficiency reserve will be needed. The name premium deficiency seems inappropriate since premiums are no longer revenue. This reserve will be the present value of the deficiency in revenue using realistic assumptions at the financial report date.

Subsequently, if experience should improve, all or part of the revenue deficiency reserve may be released, however, DAC may not be recapitalized after it is eliminated.

In other words, DAC is dynamically unlocked so long as no new loss recognition is required, but DAC written off for loss recognition is permanent. Revenue deficiency reserve is fully dynamic.

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If this interpretation is correct, then companies will need to be careful in the implementation of SFAS 97, since their financial statements in the year of implementation will vary depending on whether all prior years are restated or not, due to the ratcheting effect of DAC write-offs.

This discussion has not addressed the possibility that loss recognition may not be apparent from the amortization schedule as calculated using the credited rate, when in fact if the earned rate is used loss recognition should apply. This situation may arise since deferrable expenses typically decline with advancing duration, while gross profits typically increase. The higher earned rate will discount future gross profits more than deferrable expenses.

However, although all this sounds complicated, in actuality many companies will not readily admit that they are in a loss recognition situation, since it is easy to assume that future interest margins, loadings, or mortality margins may be increased at will so as to ensure that the present value of gross profits exceeds the present value of deferrable expense. This may be a difficult point of discussion in audit situations. Perhaps one of the panelists could comment on this point.

Finally, just to take up some specific points made by the panelists, I would not agree that loss recognition for interest-sensitive products is similar to that for traditional products under FAS 60. The procedure is more complicated due to the different interest rates involved and the dynamic variations in DAC, up or down.

One panelist referred to the possible use of a shorter amortization period to be conservative, in the face of the risk of AIDS. FAS 97 prohibits such conservatism. The risk of AIDS cannot of course be ignored, and so it should be considered when projecting death claims for loss recognition testing.

There was also reference to eliminating any overhead expenses when testing for loss recognition. FAS 97 refers to FAS 60 with regard to deferrable expenses, and FAS 60 prohibits deferral of overhead expenses since by definition they are not acquisition costs, which vary with and are primarily related to the acquisition of new and renewal insurance contracts. In other words, overhead expenses are already eliminated from the amortization process even before loss recognition is tested.

MR. CROMPTON: As far as loss recognition or avoidance thereof due to changing of the credited interest and mortality, it's a very difficult question to answer; and a lot of times, the answer has to be based on the reasonableness of the assumption made. For instance, certainly if we assume that we're going to drop the credited interest down to the guaranteed rate and avoid recoverability that way, then that's obviously not a very reasonable assumption because we'll have all sorts of adverse consequences. If we drop interest rates a little bit and avoid recoverability that way, that may or may not be reasonable. It must be judged, on the individual situation.

MR. MORROW: I think that this test for reasonableness has to be accompanied by some kind of tangible evidence. If you're talking about lapse rates, for example, then you have to ask what's the company going to do to make them better and have some tangible evidence that there is a move in that direction. I know that doesn't simplify it that much because there is always the argument that something good is going to happen in the future that will eliminate this

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recoverability problem. Another test to use is a test of time. How long do you wait for that something good to happen?

MR. MCLAUGHLIN: I don't really expect an answer cause there obviously isn't any simple answer. There are some situations which are so clear-cut that yes, loss recognition will occur. There will be many others where you get into some subjective issues. If for example, we require 100 basis points for full recoverability but we've been earning only 90 basis points and we've been doing that since inception, well do we have loss recognition or not? You know, we could make a change in the near future, to make sure that we would not have loss recognition by perhaps going to 125 basis point spread. I guess I'm just saying that in practice it's going to be a little difficult to deal with.

MR. GLASS: My first reaction was that what you propose as stages of doing this is sensible, but I'm not sure that's what the rules say. Again, we need to think about that because loss recognition is a throw back to a prior system where premiums were considered to be revenues. You've couched yours entirely in terms of where DPAC is vis-a-vis the present value of future profit calculation done in the fashion in which FASB prescribes. That makes sense, but I'm not sure that's what the rules say.

MR. MCLAUGHLIN: Well, again this I guess points to some of the difficulty. It seems to me like that is what it's saying, but I will admit that there are some things that are not clear. That seems to make sense and comply with the rules as they stand.

MR. GLASS: I think you have a strong argument for that and the other thought that comes to mind is how you will determine your amortization ratio as you begin to use this new process. I would surmise that most companies would not like to get a big surprise plus or minus, as they use this method. Big surprises, either way, are probably not a good thing from the standpoint of the reasonableness of your earnings results. I think reasonableness of earnings result is a paramount consideration. As you think about setting your amortization ratios (because you'll probably have a bundle of them, if you have a bundle of products and different years of issue and all that), you need to think ahead as to what will happen when this changes.

MR. LONNIE MILTON GRAUL: It appears to me that FAS 97 is balance sheet driven, and you either have experience that is more favorable than you led anticipated at the time deferred acquisition costs were set up or you had losses in the past and you had to write off some of your DAC. But things get better, and you have more favorable experience. The comment from Mr. Crompton seems to say that you can't recapitalize what you've already written off, and yet, that seems to be in opposition to the balance sheet driven approach, and I'm just wondering if I misunderstood or or are those two separate situations?

MR. CROMPTON: I think you understood correctly. I think the point I was trying to make was that the change in Statement 97 was the Board was trying to indicate that what we've got here is a change in the way we recognize the amortization, the way we recognize the emergence of profit. I don't think that they meant for the absence of lock-in to be applied to any sort of write down in DAC amounts as far as recoverability testing.

MR. GRAUL: Well how about in the case where you're not talking about recoverability testing, you're simply saying, "You know, I've had a change in my

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expectations. I have better lapses than I thought I would experience and that if I had it to do over again I would have more DAC on my books today than I would have had otherwise."

MR. CROMPTON: In other words, if we had known then what we know now we would have deferred more at issue. Is that the question?

MR. GRAUL: Well not necessarily deferred more at issue but amortized less.

MR. CROMPTON: That is correct. In other words, if we have to make a change in our amortization schedule what we'll do is impound all of our future and as well as our past changes in experience so that the amount of asset balance we have after we do the restatement will be different. It might be more, it might be less depending on the direction of the changes. In other words, if we say that experience is such that we've got relatively less margin and therefore a higher amortization ratio, then at the time of restatement we will have more DAC under the new schedule than we would have under the old schedule.

MR. GENE L. LUNMAN: Bob Crompton, you were pointing out adjustments made to the DPAC model. You were going to use that for loss recognition and one of the items you mentioned was expenses and I didn't really get the point. Could you expand on what you meant by that?

MR. CROMPTON: The expense numbers that we expect to go into the FAS 97 amortization model are the direct expenses. Sometimes in loss recognition testing any sort of indirect expense allocation is excluded if you can show that it is not necessary for the support of the product. It may be that some of the expense allocations that you've made for FAS 97 amortization are of this type of indirect expense allocation. Therefore if you do run into a loss recognition situation, you might challenge whether the expense numbers you have in your amortization model are all truly necessary for policy administration.

MR. GLASS: I have a thought on the previous comment that was made on loss recognition. I guess one thing that bothers me about using the present value of future profits calculation under the FASB method is the fact that it does assume that you have assets equal to the accumulated values at all times and that's not true. So I think from a loss recognition standpoint I'd probably want to take into account only the investment income that I was really going to earn.

MR. EVANS: I guess I'll just simply reiterate what I said earlier about going through the FAS 97 model, except adjusting it to use the earned rate rather than the credited rate to calculate margins. If under that process you get a FASB amortization percentage of 100%, looking at things from the point of issue will correspond to a situation where the present value of your cash flows for that product is exactly zero (i.e., a gross premium valuation that gives you an initial value of zero), that's exactly analogous to the type of recoverability testing that's described in Statement 60. So there is no need when you're using the FASB model to do anything to adjust the asset that's been used to generate the interest margin. Now the thing that brings it into balance is the fact that when you go through the FASB model to generate the earnings each year, once you've corrected the theoretical flaw in it by using the earned rate rather than the credited rate, then you are paying interest on the DAC each year and what this accomplishes, although it is a little harder to see under FAS 97 than under FAS 60, is that in effect you've replaced the fund values being used as the asset, you're actually getting interest on what will be the fund value minus the DAC.