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CURRENT TOPICS IN FINANCIAL REPORTING

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Recorder:	RICHARD S. MILLER

- o Topics of current interest in the United States and Canada, including the activities of:
  - -- NAIC
  - -- Canadian Institute of Actuaries
  - -- CICA
  - -- American Institute of Certified Public Accountants
  - -- FASB

MR. RICHARD S. MILLER: I'm the only representative here from the Tweedie Committee so I'll give a brief preview of the session at 10:30 a.m. At that session we're going to be discussing the proposed changes to the standard valuation law that are being developed currently by the Statutory Advisory Committee of the NAIC chaired by John Tweedie. The fundamental thrust of the suggestions is to require an opinion which specifically does contemplate the analysis of cash flows coming off the assets and their sufficiency to support the liabilities of the life companies. That demonstration is expected to be performed using certain tests. It's at that point that we got into one of our primary areas of concern and difficulty. The question was how deep and how detailed a test would be required to support the demonstration. We have gone to considerable length trying to define certain safe harbors, that is, considerations that would allow the valuation actuary to arrive at his conclusion of adequacy without going through the rigors of multi-scenario cash flow testing with or without stochastically generated future environments.

Inherent in our deliberations is the desire to avoid the implications of the C-1 risk. In order to do that it, is rather clear that some changes need to be made in the mandatory securities validation reserve (MSVR) to make it an adequate substitute for a direct consideration of the C-1 risk within the valuation. Certain suggestions are being developed on that. Those are not quite into the stage where they are available for release to the membership.

Dr. Allan Brender, from the University of Waterloo, has been actively participating in the dramatic changes that are going on in financial reporting for the Canadian life companies. He has volunteered to give us a synopsis of what is probably a two year process. We would hope then to have some discussion of these changes, particularly as they might eventually be adapted as changes in the situation in the United States.

DR. ALLAN BRENDER: Things are extremely active and volatile in Canada. I drew up a short list of all the projects that are going on so I could tell you what the status is of most of them. We've had a sequence of technique papers, some of which have been finalized and some are still being prepared.

Technique papers for valuation actuaries are directed at establishing, in rather a technical way, the assumptions or methods for valuation of particular products. These papers become part of the Professional Standards, and once adopted by the Canadian Institute of Actuaries, become binding on valuation actuaries. Two have been formally adopted. The first deals with so called "lapse supported products" and the maximum lapse rates that can be assumed. The second has to do with renewable term insurance and how to select mortality rates, particularly for the renewal periods. There are a number of other technique papers which are in the exposure stage. For most of them, the period for comments ended at the end of September. To give you some flavor of what we are doing, I'll tell you what the concerns are. One has to do with how reinsurance will be treated in valuation, a second has to do with the determination of the ultimate reinvestment rate. Valuation actuaries are required to choose assumptions which are appropriate. The interest rate assumption is supposed to be based upon looking to the actual cash flow that you can expect from your invested portfolio. So what we are defining a standard for is the reinvestment rate that you will assume in the distant future.

We have another paper in progress on the valuation of adjustable products and another one on the selection of mortality rates, that is, "best guess" base mortality rates. Others are being talked about, in particular a paper on how to choose interest rates for interest sensitive products. The paper on universal life is another one which is in a nebulous state of preparation. This is an extremely technical and very active piece of the work of the Committee on Life Insurance Financial Reporting. It constitutes the first of half a dozen projects. Secondly, with respect to AIDS, a task force was created toward the end of the summer, divided into three subgroups. The first subgroup is concerned with modeling of statistics for the AIDS epidemic. It is directed by one of my colleagues at Waterloo, Harry Panjer. They have just completed their work and have been making great efforts to make sure their models are consistent with those that have been used in the U.S. and particularly with the work of the United Kingdom Working Party on AIDS. As it happens, our University also is involved in a major project with the NIH in the United States so we've had a lot of input that way.

The modeling committee has just come up with its numbers. The other two subcommittees are on pricing assumptions and on valuation. The valuation people have just gotten the numbers and at this moment I'm not sure what their precise plans are. The timing at the moment is rather unfortunate since the next meeting of the CIA council and the next CIA meeting will be in Montreal in November and I can't predict exactly what will transpire. I think the hope is there will be some kind of standard for AIDS valuation for the end of this year.

One of the most active areas is this whole question of GAAP. Just to remind you one more time, Canadian law provides that basically there is only one public set of reserves. The statutory reserves are the GAAP reserves and it's the only thing the company can publish. We have not defined GAAP officially, or rather, it's not in effect yet but there has been a lot of work going on. In fact, the Canadian Institute of Chartered Accountants handbook has now been rewritten, and we supposedly have agreed on a GAAP standard which is supposed to be in effect at the beginning of 1989.

This requires that the reserving method that is used be acceptable to the regulators and adopted into regulation or into the legislation because those are the only reserves that can be used in a public sense. The method is called the policy premium method which means the valuation premium will in fact be the gross premium. The important thing is that the assumptions that one uses in the valuation will be based upon a best guess plus a specific provision for adverse deviation. The difficulty then is in specifying the provision for adverse deviation. There is a standard currently being developed. Again, the discussion period terminated at the end of September on the determination of provisions for adverse deviations. In this case, this paper specifies a minimum and a maximum range for these provisions and gives guidelines to the valuation actuary as to how to choose somewhere between the minimum and the maximum, depending upon certain criteria which are basically his perception of the risks that exist in the company. The regulators have had some difficulty with this whole idea because, in fact, no one seems to be quite sure as to how the reserves which emerge under this method will resemble or differ from the level of reserves under our current valuation method. After long debates, we reached some agreement, basically during the week before the last Valuation Actuary Symposium in Toronto. In that symposium, the Canadian sessions were in fact the first time the deal was unveiled. The regulators have agreed to adopt, in principal, the policy premium method subject to seeing effective numbers. The major part of the deal places a tremendous burden on valuation actuaries. By next June 30, 1989, companies will conduct two years worth of year-end valuations based upon the 1987 and 1988 results, using the policy premium method. We will then have complete valuations for basically the whole industry on two different bases, the current reporting basis and the new policy premium method. Then our regulators will be able to compare the results of these two valuations, each on two bases, and if they are happy with the numbers, they will adopt the policy premium method. The CICA accounting handbook specifies that GAAP will be in effect next year. Of course, there is a not-withstanding clause such that they can't require GAAP if in fact the reserve method specified is not acceptable legally.

The project involving determination of GAAP and specification of the provisions for adverse deviations has taken a lot of work and there is a lot more work going on.

We also are doing a lot of work with respect to solvency. There is a proposal, in contrast to what Dick just said, that every company and every valuation actuary will get into all the gory details of interest sensitive simulations, not only simulations of interest rates and all kinds of scenarios, but simulations of variations in any rate or any factor that materially affects the performance of a company. We're going to ask people to begin on a volunteer basis in 1989. Hopefully, solvency testing will be required in 1990 based upon 1989 year end results. This will require people to do extensive simulations of their company using a wide variety of scenarios, with projections for five years. The required opinion is whether in each case, the surplus that emerges is at least equal to a minimum surplus, which is going to be specified by a formula that will be determined by regulations that are now being prepared under the recently revised Insurance Act. We have a minimum surplus formula initially developed by the industry trade group, the Canadian Life and Health Insurance Association. I would say it is sort of an underwriting tool to allow companies to be covered by a National Guarantee Fund. Some version of that formula will be enacted into law and will be required by the regulators. So, you can see there is a tremendous amount of work still to be done. It is not clear how valuation actuaries are going to survive the next 18 months. They have to change to the new valuation system. They have to introduce a whole solvency testing process. They have to worry about AIDS.

Finally, the last two items. We have had a joint committee of the Canadian Institute of Chartered Accountants and the Canadian Institute of Actuaries which has been dealing with the relationship between the auditor and the actuary. Several years ago, this committee produced a report which many people thought was the final report. It essentially establishes an agreement that the auditor will accept the work of the actuary with respect to the calculation of reserves. There is no implied need for a second audit of the reserving process. That committee was fairly inactive but there do remain several outstanding issues, and this committee has recently been revived and is proceeding to work on these issues and wind up its activities.

With all these things going on, we find out in fact valuation actuary meetings are becoming more and more frequent. The Canadians held a separate Valuation Actuary Symposium in Toronto last March, to acquaint members with current standards. The Canadian topics at the Toronto Valuation Actuaries Symposium in September occupied the afternoon of each of the two days. The solvency testing process took one and a half of those afternoons, and discussion of the GAAP issue took the remaining time.

The upcoming meeting of the CIA in Montreal during the second week of November has been extended by a day and there is an extensive valuation actuary track that has been inserted into the program. The added day on Saturday, November 12th, will be devoted exclusively to valuation actuary issues: that is, the discussion of our new GAAP standards, solvency testing standards, and the technique papers. Incidentally, the institute placed upon itself the obligation that as part of the package of adopting GAAP and moving to these new policy reserves, there were several other things that had to be done. These are also in progress. The Institute itself would not approve the use of the policy premium method unless we had the provision for adverse deviations nailed down. The package requires us to establish solvency testing standards. Most importantly, we have to show that we have in fact tightened up on our disciplinary process and are taking measures to insure that people are doing a proper job. There is evidence of some concern that there hasn't been tremendous compliance with some of our recommendations on life insurance reporting, which are binding on the members. We are seriously investigating new increased disciplinary procedures, and in particular, discussing questions of peer review. Paul Winokur, in attendance here, is a member of the committee that is looking at peer review. Their first step will be to prepare a questionnaire which will be required of all valuation actuaries; the wrong answers could lead to potential discipline. This is a long, complicated, and involved procedure, and we could easily go on for several years discussing it.

MR. PAUL E. SARNOFF: I wanted to ask about the policy premium method. Is there a feature in it that would prevent a company from reflecting the entire profit of the policy at the time it is sold? Would you recognize the profit over a period for which premiums were paid?

DR. BRENDER: I think that the profits are front ended. That has become the major issue, particularly the major concern of the regulators as they are worried about the level of front ending of profits. The philosophy is that a company engages in two activities -- the sales activity and risk taking activity. The proponents of the policy premium method argue that recognizing profit at the time of sale is a recognition of your sales efforts. I think most of the profit, in fact, will be front ended other than what is absorbed and later released by using slightly conservative assumptions as provision for adverse deviations.

MR. PAUL WINOKUR: That was one of the problems we had in getting the chartered accountants to adopt the policy premium method as being appropriate for GAAP. They understand full well that this will permit the front ending of some profit as Al mentioned. They felt comfortable with the required provision for adverse deviation. It is still conceivable that after providing appropriate provision for adverse deviation, there may still be some front ending of profit in some instances. The one unknown is with respect to some of these technique papers. For example, Technique Paper Number 1 ties the hands of the actuary on lapse rate assumptions for lapse supported products. We're not sure what the final version of that paper will be in the GAAP environment. If the current technique papers stand in a GAAP environment, the valuation actuaries will be forbidden to use anything higher than a 3% ultimate lapse rate. Chances are such lapse supported products won't result in a front-ended profit, since companies are pricing these products at lapse rates higher than 3%. Thus, front ending will depend on the product line and it will depend on the final determination of the effect of our technique papers in a GAAP environment. A different problem may be that the valuation actuary still has a great deal of freedom. Some valuation actuaries may choose to avoid front ending profit by adopting higher margins for adverse deviation.

MR. TIMOTHY J. ADAMS: I was wondering if anything had been considered about declaring within the valuation report whether or not the investments were considered to be of investment grade.

In the United States in Schedule D for insurance companies, they have to show whether or not a bond is investment grade and then they also have a break out for the various investments by duration. I was wondering whether anything like that is being considered within the valuation report.

DR. BRENDER: I don't think so. As a matter of fact, current legislation has detailed discussions of the minimum characteristics of types of permissible investments; such items as the track record with respect to payment of dividends and earnings and so on that a company has to have before you can invest in that company. One of the features of the new act is that all of that is about to be dropped and we are moving to a prudent man rule (or Monday morning quarterback rule). This will say that you have to invest prudently and that's all it's going to say. We're moving away from any of these detailed considerations. You do have to provide the regulator a detailed schedule of all your investment holdings, but the schedule doesn't usually appear in a published statement. It appears in the copy furnished the regulators so that they do know all of your assets, but there is no public analysis of the kind you are talking about.

MR. GARY CORBETT: All the the proposed solvency formulas do reflect the quality of assets, don't they?

DR. BRENDER: Yes, the solvency formula that we're talking about is a very simple formula that takes only eighteen pages to describe. It has lots and lots of factors in there; specific calculations for asset risk, default risk, interest rate risk, mortality risk and so on. The asset risk calculations vary by the grade of the investment.

MR. CORBETT: In other words, if I wanted to have some idea of what kind of default risk a company is exposed to, I could look in that part of the calculation.

DR. BRENDER: It's not clear at this moment whether the details of the calculation of this minimum required surplus by that formula will be public at all. It's not even clear whether the amount of the minimum required would be public, because there are difficulties with publishing a number which says it is your company's minimum surplus. Everyone then looks at your actual surplus and compares them and you can start runs on the banks if things are too close. I'm not sure at this moment whether these numbers will be public. I believe there will be a separate addendum to the valuation report which will go just to the regulators.

MR. MILLER: Arnold Dickie had to leave and he's the Chairman of the Council of the Life Insurance Financial Reporting Section. He was going to give a brief discussion of what the Section itself was doing but I'll stand in for him. We did put out a newsletter this summer and I've heard at least one report of somebody who didn't get it.

I don't know why we singled a few out. In addition, the finances are in pretty good shape. We have set up to help sponsor one of the major research items that is going forward. It's anticipated that the funds that are in the treasury for the Section will be more than adequate to handle the commitment we've made. I believe it was $5,000, which is the same amount the Society was contemplating in it's allocation for that research effort. Beyond that, we have a new Council and Steve Smith is the new Chairman. The next prepared speaker we have is Dr. V. Michael Shante who is going to talk to us a little bit about the securitization of policyholder loans and more specifically about the securitization of life insurance premiums. Hopefully, this report will lead into some discussion on the appropriate financial reporting treatment for statutory and tax accounting purposes.

DR. V. MICHAEL SHANTE: I would like to bring all of us up to date on a new securitization product that is still somewhat confidential. Very few individuals know about it, but no one is willing to talk about it because it is very proprietary.

I do not wish to go into the details of what is securitization, as I think most of us know by now. Basically, it's a process to sell assets or something that looks like an asset. For our purposes, I think that should be enough of a common ground to carry on a discussion which is more relevant to valuation actuaries and to the financial reporting side of it.

As perhaps you know, earlier this year, we had securitized about $620 million of policyholder loans. Our parent company, The Prudential, had securitized and sold certain policyholder loans. The primary motives were to enhance portfolio liquidity and to redeploy the assets more constructively. Unfortunately, or fortunately as your perspective might be, the process also reduces surplus. We have since developed another securitization product that enhances statutory surplus by a very cost effective process. The idea is to securitize and sell certain portions of the gross premiums for individual life products. Anything in excess of net valuation premiums could be securitized and sold. The cash so received would be recorded as an admitted asset. To the extent we were proposing not to sell anything more than the loadings, no liability, such as a deficiency reserve, would have to be recorded. Surplus would therefore be enhanced.

This ultimately evolved into a very general concept that took us six months to research and develop. And then we started thinking about other potential applications. I should add that until about two months ago, I thought I was the only person in the world developing such a product. Then we learned that two other commercial banks were also thinking just like us. Not only on the product side but also that they thought they were the only people doing it. All three of us pretend that nobody else knows what we are doing and all three of us pretend we will never tell anybody what we are doing. That's why I would like to keep it a big secret amongst all of us.

Other people have proposed selling more than just the loadings. But that is somewhat more complicated. We have presented such proposals but only in conjunction with some new reinsurance strategies. We have also generalized the concept to make it work for revenue streams more general than just the loadings in life insurance products. The objective basically is to upfront the loadings, or other revenues, to realize their value on the balance sheet.

We thought this product would compete with certain reinsurance transactions. Pretty soon we realized that was not a fair statement because there really is no competition. For instance, in the surplus relief reinsurance transaction, one normally rents surplus at a cost of about 200 to 400 basis points depending upon the company's own credit. In our product, you do not pay any rent at all but are upfronting certain revenues. Therefore, the cost of surplus is about 200 to 400 basis points cheaper than in a surplus relief reinsurance treaty. Thus, there really is no competition.

Another type of reinsurance transaction is a coinsurance treaty. Most companies do coinsurance treaties either to realize surplus or to manage their risk profile. In a coinsurance transaction, the allowance received upfront is basically the present value of future profits in the business being ceded. This has a couple of problems. First, it is priced at a high discount rate of 10 to 15%, or whatever the reinsurers think is appropriate. Also, the allowances received are taxable when received by the ceding company at a tax rate of 34%, or whatever. The product that we developed will have different accounting treatments on two different balance sheets: On the statutory statement, we would record it as a sale. This is not quite a real sale since there is no existing asset on the balance sheet, but a sale meaning it would be recorded not as a financing but as cash received. On the tax statement, it would be treated as a financing. Therefore, no income taxes would be payable upfront, though you would pay income taxes as and when the loadings are collected and earned. There are cost benefits compared to coinsurance transactions because the tax on the surplus increase is paid on a deferred basis and because the discount rate used is lower than that used for pricing reinsurance.

Those are the two major applications of premium securitization. I thought that once we went public with the idea, every company would be delighted to hear about it. However, the reaction has been somewhat mixed. Some of the valuation actuaries and the regulators we talked with got very interested in all different kinds of ways.

By the way, one company in St. Louis has already done such a transaction. That company accounted for it as a surplus enhancement and booked $75 million as increase in surplus. The Missouri Insurance Department is well aware of the transaction and the company had an okay for the accounting treatment.

However, no other insurance company has yet undertaken this transaction. The New York Insurance Department is looking into the issues involved.

Next, let me describe the risk elements from both the buy and sell side. With the "buy side" I mean the way we structure a transaction to convert the loadings into securities and place them with other insurance companies, banks and other institutional investors. On the sell side, the risk of course is that you may have given away revenues which may not have been appropriately priced. But that risk we take all the time when insurance companies cede, sell or acquire blocks of business. So that to me is not a new risk. On the buy side, the risk is that in the case of adverse lapse rates, the revenue stream can be severely impaired. This is unlike the case of mortgages or policyholder loans where the risk is that of faster or slower than expected principal payments. Here, the securities issued could become worthless in the extreme adverse case when the lapse rate is so high that no revenue stream is left.

The other risk element on the sell side is that of what you invest the proceeds into. This is a major part of what the insurance departments are concerned about. They say you are taking your future revenue stream and upfronting it; and, how do we know that the insurance companies will not take those funds and apply them to some misguided business ventures. The regulators are looking at it from the point of view that when you upfront the revenue stream you have in a way jeopardized the future profitability of the firm. But that is exactly what is also done with coinsurance allowances. At least from my perspective, it is not any different. If anything, it is at least more cost effective.

Several accounting treatments have been discussed and I would welcome any comments on them. I can summarize four different ways to account for it. Ideally, I would like to see it booked as free surplus, just as a coinsurance allowance would have been. Alternatively, one could call it an "assigned surplus." The regulators might prefer to book it as a surplus note so that they can control the cash to be paid back to the new owners. A final option could be that an offsetting liability be recorded in the balance sheet. There is no current regulation that would lend any specific guidance along those lines. The one department that is looking at this transaction is thinking of creating a new regulation.

Requiring an offsetting liability on the balance sheet is probably not equitable to all companies. After all, not every company has positive loadings, and if a company has sold a loaded product, it has a claim on an extra revenue stream which some other company does not have. If you have sold a deficient product, you are required to set up a deficiency reserve. If you have sold a product, with two dollars of loadings or ten dollars of loadings, that is a margin that is there for the firm to utilize in any proper manner.

That basically is the current state of affairs, except that last week I was at a departmental hearing and I was told that there are two things they are leaning towards. That does not mean they have decided upon it. One is that in the case of bankruptcy of the company, all bets are off. That is, the cash flow that is supposed to go to the buyers of those loadings may not be passed through to those buyers by the conservator who instead might retain those funds. That is not necessarily a major concern from my perspective. Even in the policyholder loan transaction, the security interest was not perfected in the sense that the cash flow is not as guaranteed to the new owners as would be in the event of the simple sale of an asset such as an automobile or a building. I understand that perspective and one can live with that.

The second element the department mentioned was that they are leaning towards recording a liability to offset the cash received. That concerns me somewhat because the loadings are not required in any valuation process and because there is another similar liability which is not recorded on the books. A company could, for instance, redefine its commission scales: Instead of paying high first year and low renewal commissions, it could define an equivalent level commission scale and guarantee those renewals to the agents; and, no liability need to be recorded. The agent can now turn around and factor that commission contract to get the cash upfront. To me, the process is exactly similar. Instead of selling loadings, I can channel them through commissions contracts. So far, the departments have not come to a conclusion.

From the valuation actuary perspective, some of the people I have talked with have expressed doubt as to whether they could issue a valuation certificate if the company does undertake such a transaction. I recognize that this is a valid concern and a difficult issue. My suggestion would be to do a gross premium valuation and make sure that the company overall is still on the proper track.

MR. SARNOFF: You questioned whether there should be a liability for the future premium loadings that have been sold. It seems to me that there has been an advance premium. I don't see why a company wouldn't be required to set up a liability for a premium received in advance.

DR. SHANTE: It is not an advance premium liability if the transaction is structured so that the new owners of loadings receive cash only when and if it's collected and earned. It's not like they have a right to receive the cash from the company under any and all circumstances. It is if and only if and when the premiums are collected and earned that they get the loadings passed through to them.

MR. SARNOFF: What then if the company has collected some money from the people?

DR. SHANTE: We are not selling the premiums that the company may have received in advance. If and when the policyholder renews and pays the premiums, and the premiums become earned, the loading part of it would be forwarded to the new owners.

MR. SARNOFF: I was talking about the person who bought the loadings from the company. Did they pay a consideration to the company for it?

DR. SHANTE: They did.

MR. SARNOFF: Isn't that advance premiums?

DR. SHANTE: Advance premium normally means that it has to be refunded in the event that the policyholder wants to cancel his policy. It is a revenue that has not been earned by the company. Here, the consideration received is not booked as an advance. The purchaser has bought a contingent future cash flow. As the cash flow comes through, the person has a right to receive it. If it does not come through, the firm does not owe him anything at all. The difference is how does one legally define the transaction. If the transaction documents say that the following sums shall be paid by the firm to the buyer under all circumstances, then there is a liability. Here, there is no such "shall be paid" requirement. If the clause basically says "if and when the premiums are collected and earned, the X percent representing the loadings shall be passed through to the new buyers," then there should be no liability. Just as no liability is required to be booked for the renewal commissions payable to the agents. It is not a financing contract in which a person has bought a right to a cash flow stream. Here, the loadings are payable if and only if the company receives and earns the renewal premiums. Otherwise, nothing is payable.

MR. THOMAS F. EASON: I think Michael Shante's subject is important to talk about for a few minutes. Some of you may not be aware that there was in fact a panel discussion at the Boca Raton meeting (Spring, 1988) which included this subject. A panelist from one of the major New York banks addressed the subject of premium securitizations as his bank then viewed it. There was considerable conversation about the possibilities offered by this approach.

Here is a summary of my personal view. Major financial institutions in this country have developed techniques that make available, to companies with a need for working capital, substantial sums of money at costs which are lower than surplus relief costs generally available today. I agree with the summary just given about the the techniques involved. Properly structured, no statutory liability is created. The parallel to the surplus impact of coinsurance allowance is quite strong. Both approaches collateralize now funds that will be available later, assuming the products are priced profitably.

I would like to add to the discussion in Boca Raton. The regulators are, of course, uncertain as to how collateralization (or securitization) is going to work, in part because there has been little public information about it. Regulators are also uncertain about the way coinsurance works these days, because of the complexities of contracts and the variations used by companies which employ funds withheld, letters of credit, and other approaches.

There is no question that a properly priced product will permit a financial institution to do a collateralization. (Incidentally, sometimes this approach is described as "factoring," a very old mercantile phrase dealing with the sale of a future stream of profits.) I believe this can be done with both traditional and nontraditional life insurance products to the great advantage of the company that is involved.

The challenge for members of the Financial Reporting Section and others, especially those who work for the financial institutions, is to try to be clear about what they are doing. We should exercise considerable influence upon those who wish to use funds made available in this way, and ensure that they do not take this approach to inappropriate extremes. Companies should not collateralize a stream of future earnings which are going to be required to support the basic solvency and solidity of the company. I will stop short of trying to outline what I think will eventually be required in the form of guidelines. It may be that the regulations will be needed, even some type of model regulation, if there is excessive confusion created in the meantime.

I believe there are firms that are developing an idea that is well worth considering. My company took a long look at this approach earlier this year. I have spent a lot of time with various institutions, consulting firms, accountants, and attorneys around the country. I am convinced the approach is viable.

By way of contrast with a studied approach, I am aware of organizations that have gone to regulators with a "one-minute" discussion of what is proposed. They have been told by the regulators that, since a particular bank or institution is not a reinsurance company, they should go home and forget it. There is an axiom worth following. It is that you don't ask a regulator a question unless you know the answer. There are some folks who haven't thought things through enough, and are asking questions without knowing the answers, without having done adequate research. This conversation, I hope, will help some of you to appreciate the importance of doing the research.

I would like to take another minute as Secretary of the Financial Council. There are several points that I think should be mentioned about Section activities. We have taken the approach of adding to the involvement of the Section members by developing a committee structure for specific purposes. You all know about the newsletter, I trust, the *Financial Reporter*. Ed Jarrett is in charge of it. He has a team of people working with him. You have seen his initial issue. He is here at the meeting and has another issue about ready to go. We have invited Ed and other committee heads to attend the council meetings, to be actively involved, and to make their contributions to our discussions.

Roger Smith is also involved, working with the Society programs. He is taking over much of this responsibility from Steve Smith who has handled this so well the past couple of years. We have asked Bob Stein to become involved with the review of material submitted to the *Financial Reporter* for publication. Ed Jarrett has received a goodly number of contributions. He can't review all of them by himself and be sure of catching potentially important flaws. Bob and Ed are forming a group of four to six people to go through the submissions you and other Section members choose to make. We hope that this will ensure the quality of the material published and generate further interest.

Ed has compiled for this newsletter a major discussion of FAS 97 topics. At last report, he had approached some 14 people to make contributions, a number of these individuals being leaders in the analysis and development of FAS 97 activities.

Bill Schreiner, our man from the ACLI, is working with us on research activities. He is looking to phase out of that responsibility, according to his comment at our last meeting. He has pulled together much material and helped the Council deal with it effectively.

We have had an extensive discussion of the upcoming Vancouver Society meeting. Some 40% of the program is assigned to the Section. We have identified possible session chairmen. Roger Smith and Greg Jacobs, a new Council member, are hard at work lining up these people. If any of you have an interest in a particular session, I strongly suggest you get to Roger or Greg soon and volunteer your services. We can always add to a panel if the interest warrants it.

If you'd like to talk some more about the subject of collateralization I'll be here after the meeting and be happy to try and put some additional perspective on it as I'm sure our prior speaker would.

MR. MILLER: The remainder of this session will be brief reports by me on the status of certain other items. One of them has to do with the NAIC.

There are several proposals before the NAIC for changes which would affect Financial Reporting fairly dramatically. There are three proposed revisions to the actuarial guidelines. Two proposals are Actuarial Guidelines 9B and 9C. The old Actuarial Guideline 9 would be renumbered to 9A. Basically 9B has to do with substandard mortality within the valuation of immediate annuities, more specifically within the valuation of structured settlement immediate annuities. Guideline 9C has to do with the proposed breaking up of a single contract and reserving it according to it's identified pieces. Guideline 9B is currently progressing smoothly toward apparent adoption by the NAIC. Guideline 9C has some problems and is much more controversial. It probably will be rewritten. The adoption date for 9C is not certain. I'll stop for any questions or comments from anybody who is more expert or who would like to make a comment relative to these two actuarial guidelines.

There is also an embryonic proposal to revise Actuarial Guideline 4. Actuarial Guideline 4 was originally promulgated in the late 1970s as a method of achieving what is commonly considered to be deficiency reserves on annually renewable term. It basically said that there is great desire to use the unitary approach in determining the reserves for long duration term contracts. If the pattern of actual gross premiums is such that the early net premiums generated by that pattern are substantially less than the annual cost of insurance, the resulting reserves are considered inadequate. Additional reserves need to be set up for the guarantee of future insurance at gross premium rates which are less than annual cost of insurance. When that guideline was adopted, the regulators also adopted a more liberal mortality standard to enable companies to not have to use the full 1958 CSO. The guideline is specific in its application to policies issued under 1958 CSO. With the adoption of the 1980 CSO, the assumption in the industry has been that Guideline 4 did not apply to either indeterminate premium business or to term insurance issued under 1980 CSO. As a result, the use of the unitary approach without any investigation of the need for additional reserves has proliferated. Along with the unitary approach, several companies have returned to a pure one year term or unearned cost of insurance reserve basis. The unitary approach under some interpretations sets up a mean reserve which is negligible because the terminals are quite negative, perhaps negative enough to offset the unearned net premium. There is a regulatory attempt in the making to require the old Actuarial Guideline 4 application to 1980 CSO. The original expectation was 80 CSO with it's select and ultimate premium scales would be adequate relief for companies. Current competitive term products apparently need zero reserves in order to be economically viable. At this point, there is no formal proposal before the NAIC but something is definitely on the way.

The last item as far as the NAIC is concerned is that there was a proposal at the recent NAIC meeting to adopt a change to the existing actuarial opinion to specify that the amounts listed in Exhibit 10 had to be covered by the actuarial opinion. For many companies, the amounts listed in Exhibit 10 are substantially greater than all the amounts listed in Exhibits 8 and 9. It seemed unreasonable to have such large amounts which are usually calculated with actuarial processes exempt from the opinion. That particular proposal was defeated. I personally predict it will not remain defeated very long. The alternative is that some of the other proposals being made by the Advisory Committee to develop a new valuation law will be accelerated. This would require cash flow testing and cover everything in the balance sheet rather than just the actuarial items.

To my knowledge, there is nothing really new that has happened in the very recent past relative to FAS 97, other than people are getting into the blood and guts of trying to deal with it. That may be more than enough all by itself. As far as FAS 96 is concerned, we have a situation where the FASB has backed off and listened to some of the complaints, primarily coming out of manufacturing and industrial concerns, that the problems inherent in doing the work necessary to be able to comply with FAS 96 is so great that the companies need extra time to do it. As a result, the mandatory effective date for FAS 96 has been postponed one year. I have heard speculation that this delay might presage a complete change in FAS 96. My own reading of the situation is that the extra year will be the only change.

The last pressing item to be reported at this meeting has to do with the accounting for reinsurance. There is a session later in this meeting which gets into accounting for reinsurance. Ken Clark and Paul Winokur are on that panel. There is quite a bit of activity on the matter of Financial Reporting for the effects of reinsurance. The AICPA Insurance Companies Committee has a draft currently working. This draft concentrates on the matter of risk transfer. I personally think that the original draft has several flaws but it also has an appropriate orientation. Any final pronouncement will govern the accounting for reinsurance under GAAP. The AICPA draft tries to raise all sorts of criteria for the circumstances when reinsurance should be accounted for as a financing as far as GAAP reporting is concerned. These criteria are very similar to the criteria which the regulators are instinctively trying to arrive at for doing the same thing under statutory accounting. The whole focus is on the validity of the surplus relief type reinsurance agreements. In response to the regulators discomfort with reinsurance accounting, there has been pressure put on the FASB to come up with guidelines for statutory reporting of reinsurance contracts. The Academy Committee on Life Insurance Financial Reporting formed a subcommittee under Diane Wallace to directly go into this project. They have submitted a proposed standard to the FASB. The proposal may not yet be ready for exposure to the membership but it is an outstanding document. They have gone a fair amount of the way towards the criteria of risk transfer but have not gone the whole way towards requiring the inspection of cash flows. In many cases, such an inspection would cause a surplus relief agreement to decrease surplus. This is because the prospective cash flows are all in one direction and towards the reinsurer. Under such circumstances, the reinsurance creates a new additional liability rather than a liability offset. Such a conclusion is one that would often be obtained under the Canadian technique paper previously mentioned. Paul Winokur will report on that technique paper later.

MR. EASON: In 1990, mutual companies are going to be required to report for tax purposes their alternative minimum income in terms of a book income based on GAAP. I haven't seen anything written on how we go about that. Is there anybody here that has any idea? How extensively does a mutual company need to follow stock company GAAP in restating it's tax income.

MR. MILLER: Your question mentioned the only change specific to mutual life insurers that I was aware of that had to be made. That change to the taxable income is that acquisition costs had to be capitalized and amortized. You are quite right that there are currently no written instructions out of the treasury as to how that is to be done. The assumption within the industry is that something similar or identical to the standards for stock companies for purposes of determining deferred acquisition costs will apply. That was a lot easier to think of previous to FAS 97. Thus, the direct application of stock company GAAP deferred acquisition cost accounting to mutual companies for purposes of the alternate minimum tax is somewhat undefined. This is an area where I assume the ACLI or the mutual company group will suggest definitive guidance. My own expectation is that Treasury will take the easy way out and say the calculation of the deferred acquisition cost item has to be certified to by an independent accountant. If that becomes the case, the accountants probably will apply GAAP for stock companies as best they can.