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PRICING CONSIDERATIONS ON A GAAP BASIS

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- o Relationship between ROI and ROE
- o Profit objective
- o Effect of SFAS 96 and SFAS 97 on the emergence of GAAP earnings
- o Pre-tax versus after-tax pricing

MR. BRADLEY M. SMITH: The environment life insurance companies find themselves in is significantly more complicated than that of just a few years ago. Managements are facing an uncertain investment environment, the real possibility of deteriorating future mortality due to the spread of the AIDS virus rather than continued improved mortality, alternative and competing distribution systems, increasing government involvement both at the state and federal levels, competition for the consumers' life insurance dollars from external industries, the increasing presence of companies from outside the U.S. within the U.S. marketplace, as well as the specter of a consolidating industry where the poor performers are absorbed by their competitors. All of these developments have contributed to innovative product offerings as well as a shortening of the product cycle. The product development function within life insurance companies has likewise evolved from being primarily premium determination to including product design, market identification and penetration estimation, producer compensation determination, contemplation of investment strategy and determination of appropriate statutory and GAAP financial statement methodologies.

The introduction of a new product is a tactic used by the management of a company attempting to fulfill the objectives defined by its underlying corporate strategy. The product will be successful, and therefore should be judged so, only to the extent that it is consistent with and enhances the company's ability to attain those objectives. The emergence of earnings (on a GAAP and statutory basis) as well as the level of earnings must be consistent with these objectives.

Typically, the pricing process, which is appropriately a subset of the product development function, has addressed the level of earnings and not the emergence of earnings of a product. Thus, the pricing process has attempted to ensure that the return on invested capital anticipated when issuing a new product exceeds, by an appropriate margin, the cost of that capital. It has not attempted to ensure that the emergence of that return is consistent with the needs of the company. A company acquired through a leveraged buyout has requirements that are tied to statutory results. GAAP results are typically less important to such a company. A company whose stock is traded in the public markets is typically concerned with historical and projected profitability on a GAAP basis. This teaching session will address the various forces affecting the emergence of GAAP earnings on products sold in today's insurance marketplace and how they affect the product development process. Additionally, we will discuss the profitability demands being placed on the insurance industry as seen through the eyes of individuals and entities investing in the industry.

The last thing that an actuary involved in his company's product development process wants is to explain to a heretofore unsuspecting Chief Executive Officer (CEO) why increased sales resulting from the introduction of a new product have not resulted in the GAAP earnings growth anticipated by the CEO. The level of GAAP earnings, which determines the company's return on equity (ROE), will affect the perception held by outsiders of the company, thus affecting a publicly traded life insurance company's stock price. This directly affects the company's ability to raise capital which may be needed to implement its long-term corporate strategy. Thus, differences in the emergence of earnings anticipated by the CEO and those occurring solely to the application of differing accounting methodologies can have disastrous ramifications to the successful implementation of the company's plan. Yet, this is occurring with increasing frequency within life

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insurance companies due to ever-evolving accounting standards that have resulted in an emergence of earnings on products offered today that differ substantially from the emergence of earnings using Statement of Financial Accounting Standards (SFAS) No. 60 methodologies. In short, there is a difference between the expectations of the CEO and the actuality presented by these new accounting standards. It will be the actuary's responsibility to close this expectation gap. Clearly, this will be less painful prior to the introduction of a new product than it is after the product has been introduced and initial earnings emergence proves disappointing. It is well documented, but seemingly not as well understood, that most CEOs hate surprises and a major aspect of an actuary's job function boils down to avoiding these surprises.

Since this session will be concerned primarily with the emergence of GAAP earnings on products seen in the marketplace, we're going to discuss the pronouncements that affect the emergence of GAAP earnings of a product. Obviously these are SFAS No. 60, SFAS No. 97 and SFAS No. 96. The premise that I have in this session is that everybody understands the ramifications in the emergence of earnings of products under SFAS No. 60. In fact, that is part of the problem: that people are pricing at a certain level and translating that in their mind to an emergence of earnings that is similar to that under SFAS No. 60. Emergence of earnings under SFAS No. 97 for products is quite different than under SFAS No. 60. The effect of SFAS No. 96 dealing with accounting for deferred taxes will also affect the emergence of these products.

SFAS No. 97 promulgates the appropriate accounting methodologies for universal life products, investment contracts (Single Premium Deferred Annuities [SPDAs], Flexible Premium Deferred Annuities [FPDAs], Guaranteed Issue Contracts [GICs], structured settlements), limited payment contracts and policy replacement situations and has definite implications as to desirable product design. SFAS No. 96: Although as of this writing, the date of adoption and methodologies of this standard have not been finalized, recently, a subcommittee of the Financial Accounting Standards Board (FASB) recommended that the deadline for adoption be postponed for another year. Implementation in its current form will have major effects on the after-tax GAAP earnings emergence of various products offered by life insurance companies.

If surprises are to be avoided, the financial reporting methodologies must be understood by all those involved. Financial reporting methodologies should be determined and identified during the product development process, thus allowing for the possibility of altering the product design where necessary to meet company expectations. There are variables in the accounting methodologies that can be used (i.e., Deferred Acquisition Cost [DAC] amortization period) and these should be understood and set so as to meet company objectives within the boundaries of acceptable accounting practice.

What we'll do is talk about SFAS No. 97 first, SFAS No. 96 and then I want to talk a little about what I believe to be the profit objectives being set by investors in the life insurance industry.

First let's talk about SFAS No. 97 and its effect on universal life contracts.

SFAS No. 97 dictates that we use the retrospective deposit approach in accounting for universal life. Part of that approach deals with the liability side and part of it deals with the asset side of the balance sheet. On the liability side of the balance sheet for universal life contracts and for investment contracts such as SPDAs and FPDAs, the benefit reserve is set equal to the account value not reduced for surrender charges. The deferred acquisition cost and unearned revenue liability are amortized in proportion to gross profits discounted at the credited rate. The deferred acquisition costs are clear. The unearned revenue liability represents a front-end load. On any front-end load universal life contracts, you cannot take the front-end load into earnings in the first year. You actually capitalize that as a liability and amortize that off, presumably using the same methodology that you're amortizing DAC off with. The income effect is equivalent to netting the front-end load against DAC. But by doing this, it gives you a balance sheet approach where you set up the asset and you set up the equivalent liability. The question is how do you develop the gross profit stream?

The gross profit stream actually is a lot simpler than it first looks. The revenue side is investment income which includes investment income on the account value and investment income on cash flows throughout the year. Typically, in the first year you have a significant strain. The issue that comes up is that you don't have any investment income, but the reality is that you have allocated investment income to interest on the account value.

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DEVELOPMENT OF GROSS PROFIT STREAM

Revenue:

- Investment Income
- Cost of Insurance (COIs) Collected
- Level Loads Collected
- Surrender Charges Collected

Expense:

- Death Benefits
- Reserves Released (Death)
- Maintenance Expense
- Interest Credited

Gross Profit

Other revenue items include the COIs collected, level loads collected (front-end loads again are capitalized and amortized) and surrender charges collected. The expenses include the death benefits, reserves released on death (actually account values released on death), maintenance expenses and interest credited. That's equal to the gross profit.

The components of gross profits must be shown in the income statement presentation. However, it is not necessary to identify these components in the calculation of the amortization schedule. In order to calculate the amortization schedule as a product development actuary you really don't need to go through that process. There's a much simpler equivalent approach. You can restate gross profits as book profits in the year plus capitalized acquisition expenses minus unearned revenue liability (minus front-end loads essentially) where gross profits are calculated using the account value (not decreased by surrender charges) as the reserve. So you could actually put in your profit study the full account values and take out your capitalized acquisition expenses and take out your capitalized unearned revenue liability (or front-end load) and get your stream of gross profits.

Gross Profits t =

Book Profits t + Capitalized Acquisition Expense t

- Capitalized Unearned Revenue t

Where Book Profits t is calculated using the account

value (not decreased by surrender charges) as the reserve.

This equation is equivalent to the prior equation so you can get an idea of how the gross profits are going to emerge and therefore you can get a feel for how the DAC and any capitalized liability will be amortized. You can see what the emergence of GAAP profits is in the product. This is particularly important because it simplifies understanding the GAAP accounting process for these products. Let's take an example. This is a four-year universal life. This example assumes a 0% credited rate.

FOUR-YEAR UNIVERSAL LIFE

<u>Year</u>	<u>Book Profits</u>	<u>Capitalized Acq Expense</u>	<u>Unearned Revenue</u>	<u>Gross Profits</u>
1	\$20	\$130	\$100	\$50
2	70	20	0	90
3	60	0	0	60
4	50	0	0	50
PV (@ 0%)	200	150	100	250
Amort %		60%	40%	

We've got book profits as defined previously using the full account value as the reserve of \$20 in the first year, \$70 in the second, \$60 in the third and \$50 in the fourth. In this very simple example, we've got capitalized acquisition expenses of \$130 in the first year, \$20 in the second and

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\$0 in the third and fourth years. We also have an unearned revenue liability of \$100 in the first year (this is a front-end loaded product) and \$0 in years 2 through 4. Gross profits in the first year are equal to \$50, which is equal to \$20 book profit plus adding in the capitalized acquisition expense, minus \$100 capitalized liability.

Likewise, in the second year you have \$70 plus \$20 equal to \$90 and so on. I'm assuming in this example (just to make it easy and understandable) that the credited rate is 0%. Remember you're using the amortization interest rate equal to the initial credited rate. So your present value of book profits is \$200, present value of capitalized acquisition expenses is \$150, unearned revenue liability is \$100 and gross profits is \$250. The key percentages are the 60%, which is the capitalized acquisition expenses as a percentage of your gross profits, and the 40%, which is the capitalized liability or unearned liability as a percentage of your gross profits.

As we go on, here again is our four-year universal life.

FOUR-YEAR UNIVERSAL LIFE

<u>Year</u>	<u>DAC</u>	<u>Unearned Revenue</u>	<u>GAAP Book Profit</u>
1	\$100.00	\$80.00	\$40.00
2	66.00	44.00	72.00
3	30.00	20.00	48.00
4	0.00	0.00	40.00

$$100.00 = 130 - .60 * 50$$

$$66.00 = (100 + 20) - .60 * 90$$

$$30.00 = 66 - .60 * 60$$

$$0.00 = 30 - .60 * 50$$

$$80.00 = 100 - .40 * 50$$

$$44.00 = 80 - .40 * 90$$

$$20.00 = 44 - .40 * 60$$

$$0.00 = 20 - .40 * 50$$

$$40.00 = 20 + 100 - 80$$

$$72.00 = 70 + (66 - 100) - (44 - 80)$$

$$48.00 = 60 + (30 - 66) - (20 - 44)$$

$$40.00 = 50 + (0 - 30) - (0 - 20)$$

As you can see, at the end of year 1 we have \$100 of deferred acquisition cost. The \$100 you see in the far left-hand side is equal to \$130 of capitalized acquisition expenses times the 60% which is present value of acquisition expenses divided by present value of gross profits times \$50 which is gross profit in the first year. Again, \$60 is the amortization percentage, \$50 is the gross profit and \$130 is the acquisition expense. Likewise, in the second year we have \$66 of DAC outstanding which is the \$100 outstanding from the prior year plus the \$20 of capitalized acquisition expense minus the 60% amortization percentage times the \$90 of gross profits and so on. The unearned revenue liability is amortized very similarly where you have unearned revenue liability of \$80 at the end of the first year which is equal to \$100 of capitalized liability minus 40% times your gross profit stream which is \$50. So your GAAP book profit in this example in the first year is \$40 which is the \$20 from your book profits that you used to develop the gross profit stream which was without capitalized acquisition expense but using the full account value as your liability plus the increase in DAC minus the increase in your unearned revenue liability. Likewise, in the second year you have \$72 which is \$70 book profit plus the increase in DAC which is \$66 minus \$100 minus the increase in liability which is \$44 minus \$80 and so on.

This is a very simplified example, but it shows you the workings of the process. SFAS No. 97 is much more complicated. You have to worry about unlocking and things like that, but within the product development process it is less burdensome. You're really trying to see what the emergence of earnings under your different scenarios are.

FROM THE FLOOR: Will you define what goes into the unearned revenue liability?

MR. SMITH: The unearned revenue liability is basically front-end loads. The statement is very clear that a priori front-end loads are unearned revenue liability. Additionally, it was clear that a priori attained-age COIs do not have any component of front-end load. Even though you have an attained-age COI pattern with select and ultimate mortality, there's presumed to be no front-end load there.

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The difference between two products that look exactly the same is interesting. You could have an anti-select and ultimate COI schedule and use that product in two different markets. In one market that product would have a front-end load and in another market that product wouldn't. For instance, anti-select and ultimate COIs are sometimes used in the salary deduction market where you have a lot of guaranteed issue. So the first three years the COIs are higher than the attained-age schedule. That would not necessarily have a front-end load associated with it because the assumed mortality would also be increased so that the increased COIs reflect the increased expected mortality and therefore no front-end load is developed. But if you had that same product with an anti-select and ultimate COI schedule and it was a fully underwritten product, it clearly would develop a front-end load. So some judgment is required as to where a front-end load is and where it is not.

I've had a number of clients ask me, "I've got a front-end loaded product and is there any way that I can say that an unearned revenue ability is not created?" It's very difficult to justify anything other than capitalization of that front-end load. There's been less pressure to do that because in the restatement process capitalizing that front-end load will help future earnings. It hurts prior earnings; but in the restatement process, it will help future earnings. Companies are more than willing to restate. You'll see as we go along why the emergence of GAAP earnings on new sales of front-end loaded products is not very desirable prospectively. If anybody is still selling them and they're concerned with emergence of GAAP earnings in their generation or their child's generation, they'll stop. I had a CEO tell me that he hated this method. Of course, they had a lot of front-end load and sold a lot. He didn't mind using this method or using a more theoretically correct method than what he was using (which was very aggressive), but he hated to defer all of the earnings to his grandchildren. That's what he felt he was doing.

Let's talk about the emergence of earnings on back-end versus front-end load products.

Here's an example. Let's take two universal life products: one back-end loaded and one front-end loaded with the same GAAP profit margin, GAAP profit margin being defined as pre-tax book profits divided by present value of premium.

Issue Age: 35
 Face Amount: \$100,000
 Annualized Planned Periodic Premium: \$1,000

PRE-TAX GAAP EQUITY

End of Policy Year	Level Percent of Premium		FAS No. 97	
	BE	FE	BE	FE
1	\$105	\$105	\$ 63	\$ 60
2	229	229	173	137
3	371	371	327	232
4	534	534	509	348
5	716	716	701	486

BE refers to back-end loaded product
 FE refers to front-end loaded product

Profits as a level percentage of premium emerge in years 1 through 5 under a SFAS No. 60 approach. This shows pre-tax GAAP equity, and pre-tax GAAP equity is the same for both products all 5 years. Using the SFAS No. 97 approach, the pre-tax GAAP equity changes greatly. You can see that the back-end loaded product has \$63 of earnings in the first year and the front-end loaded product has \$60 in the first. The second-year retained earnings or pre-tax GAAP equity increase to \$173 for the back-end product and \$137 for the front-end product and so on. After the first 5 years, you've got \$701 having emerged on the back-end loaded product and \$486 on the front-end loaded product. That's a tremendous difference. The difference is due to the fact that surrender charges on the back-end loaded products are allowed to come through partially into net income when collected whereas on the front-end loaded products, the loads are strictly used to offset deferred acquisition costs one for one.

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To summarize, the reported earnings in the early years on the front-end loaded product are substantially below those reported on the back-end loaded product since front-end loads offset deferrable acquisition expense 100% and do not contribute to reported earnings whereas surrender charges on the back-end loaded product partially offset capitalized acquisition expense and partially contribute to reported earnings.

A similar result occurs when comparing the emergence of earnings for a front-end loaded versus back-end loaded SPDA or FPDA since these contracts will be accounted for using the retrospective deposit method.

It doesn't matter that it's universal life (UL) or SPDAs or FPDAs. You're using the same methodology so that front-end loaded products are going to get hit very severely or we're going to delay the emergence of GAAP earnings on front-end loaded products by comparison to back-end loaded products. It's something to consider if your company is concerned with the emergence of GAAP earnings, i.e., the decision to go front-end or back-end. Certainly the accounting treatment and its effect on the emergence of earnings will affect that decision.

Consumer pressure has moved the general market towards offering back-end loaded products. Certainly SFAS No. 97 encourages this movement.

The Universal Life Model Regulation allows larger surrender charges on fixed premium products. Thus, the movement towards offering products with back-end loads may also lead to the movement towards fixed premium interest sensitive type products.

I definitely see this as happening in the marketplace. The fundamentals of the flexible premium products are such that SFAS No. 97 has forced companies to actually study their experience. They see that their premium suspension is much greater than was anticipated in the original pricing. That's moving them towards fixed premium products. Additionally, SFAS No. 97 along with consumer pressure is forcing companies to go to back-end loaded products. The Universal Life Model Regulation is allowing for larger surrender charges on fixed premium products as opposed to flexible premium products. So all of the pressure is moving the market toward fixed premium interest sensitive life back-end loaded type products.

Certainly if you're going to the high compensation market (100-130% first-year compensation to the producer) you have to go with a fixed premium product in my mind.

One other aspect of SFAS No. 97 is accounting for internal replacement programs. When surrender of a life insurance contract is associated with an internal replacement by a universal life-type contract, unamortized acquisition costs associated with the replaced contract and any difference between the cash surrender value and the previously recorded liability shall not be deferred in connection with the replacement contract. Why is that important in the product development process?

This was a real bonus to companies that had massive internal replacements on their books when SFAS No. 97 was promulgated. If you could identify those replacements and if you had carried over the DAC from the replaced policy to the new policy, you basically had to restate that DAC or take it down. If you took it down through prior year's earnings, which nobody really cared about, it allowed you to clean up the balance sheet. You took down prior year's earnings and you decreased DAC. Obviously, that was going to improve reported earnings in future years and it was a real bonus to a lot of companies.

Companies that were very aggressive in accounting for replacement contracts are getting to, and in fact, have to re-report earnings that they've already reported. That's the reality. The problem is prospectively if you go into any replacement program and you've capitalized acquisition expenses on the policy that is to be replaced (which obviously you would have) and you replace that product, you will now take the DAC down on the replaced policy. On the replacement policy, if you don't have as much additional expense, which presumably you won't since it's a replacement, you will not be able to put it back on the balance sheet. You're going to take a GAAP hit in the year that you replaced those policies. It's something to consider if you're proceeding with an internal replacement strategy.

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Throughout this I'm going to emphasize a lot of the accounting methodologies. I'm not advocating making decisions based on non-fundamental issues such as the accounting treatment. Obviously, you should make the decision based on how you're going to improve your company's overall net value, but associated with that I think the reality is that you have to be aware of the GAAP accounting treatment and be concerned with how that's going to be perceived, particularly for companies traded in the public market.

Let's talk about limited payment contracts. There are not a lot of people selling limited payment contracts, but there are two distinct niche markets that depend on limited payment contracts, i.e., home service companies and pre-need funeral companies. This, it seems to me, was almost a throw-in to SFAS No. 97. It is really hurting the GAAP emergence of earnings for these companies.

Limited payment contracts are defined in SFAS No. 97 as follows: 1) having terms that are fixed and guaranteed meaning they are not universal life contracts; 2) subjecting the insurer to risks arising from mortality and morbidity and thus are not investment contracts; 3) not universal life contracts; and 4) having premium paid over a period shorter than the period over which benefits are provided.

Let's talk about some general concepts. The benefit period does not include the subsequent period over which policy proceeds are disbursed. For instance, you cannot call your contract a limited payment contract because you have a supplementary contract attached to it, which is what this provision of SFAS No. 97 was attempting to address.

The liability for policy benefits shall be established in accordance with the provisions of SFAS No. 60. Basically you're going to calculate your benefit reserve exactly the same as you calculated your benefit reserve before SFAS No. 97. You're going to have an additional liability that you're going to set up called an unreleased profit liability, but that's in addition to the policy benefit reserve.

The concept is that the collection of premium does not represent the completion of the earnings process.

Any gross premium received in excess of the net premium (benefit and expense) shall be deferred and recognized in income in a constant relationship with insurance in force or with the amount of expected future annuity benefit payments for an annuity contract. You're going to set up an additional unreleased profit liability for limited payment contracts such that your GAAP profit does not emerge as a level percentage of premium plus the release from risk component that is dictated by SFAS No. 60. The profit is going to emerge as a level per thousand dollar face amount in force.

The concepts of recoverability, loss recognition, and lock-in still apply to limited payment contracts whereas recoverability still applies for universal life contracts. Loss recognition obviously still applies, but lock-in does not still apply for universal life type contracts.

Margins for adverse deviation in accounting for limited payment contracts are still required. There are no margins when determining the accounting treatment for universal life and investment type contracts. That's a big difference which is why it is nice in your pricing system to go ahead and incorporate your SFAS No. 97 calculations for universal life and investment contracts straight into that system because there is no required margin for adverse deviation when accounting for universal life and investment contracts using the retrospective accounting deposit approach.

Premiums for limited payment contracts are still considered to be revenues in the income statement presentation for limited payment contracts. Premiums are not revenues in universal life. That did not change for limited payment contracts. So you're going to calculate your benefit reserve and your DAC exactly the same way as you did prior to SFAS No. 97, but you're going to set up this additional liability. The question is, "How do you do this?"

You calculate GAAP factors using assumptions that include appropriate margins for adverse deviation and apply SFAS No. 60 methodology to get your DAC and benefit reserve.

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Capitalized acquisition expenses are thus amortized over the premium paying period. This is going to be important when we get into SFAS No. 96 concepts. Your DAC is going to be off the books in the premium payment period, and that's going to have a major effect on the emergence of earnings and the accounting for deferred taxes under SFAS No. 96.

GAAP profits would emerge as a level percent of premiums and as actual experience deviates from GAAP assumptions if you had stopped at this point. What you do is calculate your level annual profit per unit of benefit in force using GAAP assumptions. You hold an additional unreleased profit reserve such that the level annual profit per unit of benefit in force would emerge if GAAP assumptions were realized.

Let's go through an example:

TWO PAY, FOUR-YEAR TERM

Year	Premiums	Acquisition Expenses	Maintenance Expenses	Face Amount In-force	Benefits	Profits
1	\$1,100	\$230	\$11	\$15,000	\$250	
2	900	0	9	11,000	350	
3	0	0	0	8,000	450	
4	0	0	0	6,000	500	
PV (@ 0%)	\$2,000	\$230	\$20	\$40,000	\$1,550	\$200

Here we have a two-pay, four-year term contract, obviously a limited payment contract under the definition. You have premiums of \$1,100 in the first year, \$900 in the second, acquisition expenses of \$230 in the first year, maintenance expenses of \$11 in the first year and \$9 of maintenance expenses in the second year. Obviously, this is a simplified example because you would have maintenance expenses in years 3 and 4 but to make the example understandable I didn't want to have a negative DAC. Face amount in force by year is shown as \$15,000, \$11,000, \$8,000 and \$6,000. The benefits paid in the contract are \$250, \$350, \$450 and \$500. You can see at the bottom line I've calculated the present value of profits. I'm assuming that the GAAP interest rate when I'm calculating my GAAP factors is 0% to make it quite easy. The present value of premiums is \$2,000, acquisition expense is \$230, maintenance expense is \$20, face amount in force is \$40,000 and benefits is \$1,550. So the present value of profits on the product is \$200.

If GAAP assumptions are met, results under SFAS No. 60 methodology would be as follows:

Year	Profits	DAC	End of Year Benefit Reserve
1	\$110 ¹	\$103.50 ²	\$602.50 ³
2	90	0.00	950.00
3	0	0.00	500.00
4	0	0.00	0.00

$$^1110 = 1100 - 11 - 250 - 230 + 103.50 - 602.50$$

$$^2103.50 = 230 - 230 * 1100/2000$$

$$^3602.50 = 1300 - 900 * 1550/2000$$

You'd have profits in the first year of \$110, DAC of \$103.50 and benefit reserve of \$602.50. The \$110 is equal to the \$1,100 of premium minus the \$11 of maintenance expense minus the \$250 of benefits minus the \$230 of acquisition expenses plus the \$103.50 increase in DAC minus the \$602.50 increase in benefit reserve. Likewise, in the second year your DAC is \$103.50, which equals \$230 (the capitalized acquisition expense), minus \$230 times \$1,100, which are the premiums in the first year, divided by \$2,000, which is the present value of premiums for the entire period. The \$602.50 is the present value of future benefits, which is \$1,300 at the end of the first year prospectively minus the present value of future benefit premiums, which is \$900, which is the gross premium, times \$1,550 divided by \$2,000, which is the present value of the benefits in the prior example.

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This is if GAAP assumptions are met, so basically the inherent assumption here is that I had margins for the adverse deviation in the GAAP assumptions. I needed them because the actual experience was the GAAP assumptions. You can see that profits in this emerge over the premium paying period for two years.

If GAAP assumptions are met, results under SFAS No. 97 would be as follows:

<u>Year</u>	<u>Profits</u>	<u>DAC</u>	<u>Benefit Reserve</u>	<u>Unreleased Profit Reserve</u>
1	\$75 ¹	\$103.50	\$602.50	\$35 ²
2	55	0.00	950.00	70 ³
3	40	0.00	500.00	30
4	30	0.00	0.00	0

¹75 = 200 * 15,000/40,000

²35 = 110 - 75

³70 = (110 + 90) - (75 + 55) = 40 + 30

You can see the profits are going to emerge over a four-year period because benefits are provided over a four-year period and profits are essentially a level percentage of the benefits provided. You have profits in the first year of \$75, which is \$200 present value of profits, times \$15,000, which was the face amount in force at the beginning of the first year, divided by \$40,000, which was the present value of face amount in force. So your unreleased profit reserve in the first year (the \$35) is equal to \$110, which is the profit that you released under SFAS No. 60 before you set up this reserve, minus the \$75, which is what emerged in the first year. Likewise, your unreleased profit reserve at the end of the second year is \$70, which is equal to the \$110 (SFAS No. 60), plus \$90 (SFAS No. 60 in year 2) minus the sum of the first two year's profits under SFAS No. 97, which is \$75 plus \$55, which is also equal to \$40 plus \$30, which is the profits that emerge in years 3 and 4.

So you can see that the whole thing hangs together and what you have to do basically is set up additional reserve factors. If it's a traditional product, lock-in is still appropriate. You can set up your factors when you design the product. In fact, it's very easy for the product development actuary to do. I would recommend that the product development actuary actually go ahead and do it so that he or she could see what the emergence of earnings under SFAS No. 97 will be.

FROM THE FLOOR: Would a 20 pay life be considered a limited pay product?

MR. SMITH: Theoretically, yes. I think what you're going to find with most companies' withdrawal assumptions and relatively high GAAP interest assumptions is that the emergence of earnings at issue is quite similar using SFAS No. 60 and SFAS No. 97 methodology. Remember, all you're trying to do is release profits as a level percentage of benefits in force. If you have 2% or 3% of your people in force at the end of 20 years and it is a present value calculation, you're going to find that it is quite inconsequential. The mistakes that a lot of companies made in the restatement process was to say that the 20 payment life products are inconsequential and the life paid up at 65 products were inconsequential and the auditors bought off on that. If you thought about it what you wanted to do on existing in force was to bump that unreleased profit reserve up under the concept that if you increase the liability future earnings are going to be increased because the liability is going to be released thus increasing future profits. If the company decided to blow off 20 payment life contracts that were issued 15 or 16 years ago, those that are in force now would have a substantial unreleased profit reserve and you could have increased your current liability thus decreasing your GAAP equity and increasing future earnings. By definition this is going to increase the numerator of an ROE calculation and decrease the denominator, thus really increasing your ROE. A lot of companies didn't do this. I'm sure that companies that are in the pre-need funeral business and home service business realized what kind of liability we're talking about here.

The level annual profit per unit should be calculated using a discount rate equal to the assumed GAAP investment earnings rate. In this example I used zero just to facilitate understanding.

The level of the unreleased profit reserve varies depending upon the assumed level of profitability of the product. This is critical, too, because in the restatement process the profitability of

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products issued in the early 1970s and late 1960s was much more substantial than the profitability of products now. You basically have to use your GAAP assumptions back then to restate. Right now the profit margins might not be as great. Although in the two niche markets I mentioned, the pre-need funeral business and the home service business, the margins are still quite substantial so that your unreleased profit reserve is going to reflect that level of profitability.

An examination of a limited payment whole life contract offered a number of years ago revealed an unreleased profit reserve at the end of the premium paying period of \$25 per thousand of face amount. The question here from a product development process is what kind of liability is going to emerge when you issue a limited payment contract. The answer is probably the only ones doing much limited payment business are the pre-need funeral and the home service companies and for those companies we're finding that the liability can get quite large. We're talking about a buildup of substantial unreleased profit reserve, particularly for very limited payment contracts such as single premium and three-pay.

FROM THE FLOOR: Are you required to go back and set up the unreleased reserve?

MR. SMITH: You needed to do that in the first statement released after December 15, 1988 which is presumably the first quarter of this year. But a lot of companies are lagging behind. They're making estimates for the effect but have not actually quantified the effect and are anticipating doing that in this last quarter for their annual statement.

SFAS No. 96. The nice thing about SFAS No. 96 is that it affects candy bar companies, oil companies, etc., and everybody is having as much trouble with it as the life insurance industry. So instead of getting 22 or 23 people showing up at hearings, they're getting a lot more. SFAS No. 96 has to do with the accounting for deferred income taxes. Recently required implementation was delayed for another year, which is the second delay. However, it wouldn't surprise me if in one or two years it was adopted in its current form and that's the form we're going to talk about.

In its current form, the deferred tax liability is recalculated each year by applying the current tax rate to a projected taxable income stream defined as the reversals of GAAP to tax balance sheet differences as of the statement date. There is no discounting for the time value of money. Basically all you're doing is taking the basic tax rate (let's assume that it is 34%) and applying that to a stream of income that is defined as the reversals of your GAAP tax balance sheet differences. In life insurance companies, the biggest differences are your net GAAP reserve to your tax reserve or your DAC and your benefit reserve to your tax reserve. That's why actuaries are so intricately involved in this process.

The calculation of the deferred tax liability reflects currently enacted tax law. Therefore, tax losses can be carried back 3 years and carried forward 15 years. New business and flows from existing business other than the GAAP to tax differences are not considered in the projection of net taxable income. What we have created here is a very artificial environment. We're going to apply a tax rate to this artificial taxable income stream and we're going to apply the limitations of the tax law (i.e., 3 years back and 15 years forward) to that stream. We're not talking about projecting premium flows from existing business or projecting death benefits or surrenders from existing business. We're talking about projecting the net GAAP liability to the tax reserve liability difference and projecting that on existing business only.

Taxable Income = Increase in Net GAAP Reserve - Increase in Tax Reserve

The accountants will tell you that there are other items in a life insurance company such as amortization of discount on bonds which are handled differently for GAAP and tax and that is certainly true. But this formula represents probably 80-90% of what SFAS No. 96 is attempting to get at. What you're assuming is GAAP income of zero after you've subtracted out the net GAAP reserve. So you're going to add back in the increase in net GAAP reserve and you're going to subtract the increase in tax reserve and that gives you the taxable income stream. Your taxable income for the 3 years that you carried back is your actual taxable income on your Federal Income Tax statement. Translating that formula:

Taxable income = $(BR_t + URP_t + UER_t - DAC_t) - (BR_{t-1} + URP_{t-1} + UER_{t-1} - DAC_{t-1})$

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where: BR is Benefit Reserve
URP is Unreleased Profit Reserve
UER is Unearned Revenue Reserve
DAC is Deferred Acquisition Cost

Taxable income is equal to benefit reserve in time t plus unreleased profit reserve from limited payment contracts in t plus unearned revenue liability in t , which is your front-end loads on universal life minus DAC minus the quantity of benefit reserve in the prior year plus unreleased profit reserve in the prior year plus unearned revenue liability in the prior year minus DAC in the prior year. That's basically your taxable income stream. It's very difficult to conceptualize but when you start playing with the product, it's pretty easy to do.

These differences telescope to their current GAAP to tax difference over the life of the policies. However, due to the limitations on loss carrybacks (3 years) and loss carryforwards (15 years), some of the losses do not offset corresponding gains and therefore the deferred tax liability may be in excess of 34% of the current difference. This is the critical issue for product development actuaries. If you were allowed to project these differences forever and you aren't discounting with interest, they're all going to telescope to the net GAAP to tax difference at the end of the current year. So your deferred tax liability would be 34% of the net difference. The problem is that the release of the reserves on differing products varies. The worst situation is limited payment contracts where you have, under this artificial stream, high positives in the first few years and then a stream of negatives with no positives offsetting them. The buzz word that accountants use for that is "naked debits." So if you have a stream of naked debits or negative taxable income, that negative is not offsetting your positive. In order to calculate your deferred tax liability, what you're going to do is take the current tax rate times the sum of the positives. The negatives in the stream can't get carried back, and therefore what you're going to get is 34% times a stream of positives which is essentially going to give you a larger percentage times your current tax GAAP difference.

The following products may have an initial deferred tax liability in excess of the applicable tax rate times the initial net GAAP to tax reserve difference:

- o Back-end loaded universal life
- o Limited payment contracts

You can get into a lot of problems if you have a lot of positives and a lot of negatives, i.e., the naked debit issue. You can also get into a lot of problems if you have a lot of negatives early and positives later. Basically the back-end load product, depending on how your surrender charge interacts with your tax reserve, will get you into this problem.

Obviously, limited payment contracts are going to cause you a big problem because what you're doing in the early years is building up this liability, this unreleased profit reserve, and your DAC (in a two-payment contract) goes to zero at the end of the second year. Your reserve is building up because of the unreleased profit reserve so that you've got a high GAAP reserve and a relatively low tax reserve. What's going to happen is that you're going to get a lot of naked debits or naked reversals in the later years so that when you calculate your deferred tax liability (34% times the stream of positives), you're going to come up with a deferred tax liability that's much larger than the 34% times the initial difference.

Front-end contracts are pretty well-behaved because although you capitalized the additional liability on GAAP, which is the unearned revenue liability, it's offset by your DAC. Whole life contracts typically don't have a problem. It's limited payment contracts and back-end load universal life contracts and back-end load annuity contracts that have a problem. That's bad because everyone is selling back-end load universal life. If SFAS No. 96 is adopted in its current form, it might affect the sale of these contracts. If it's not adopted in its current form, which is what everyone is pushing for, then let's take the current tax rate times the net GAAP reserve to tax reserve difference. Then what happens is everything telescopes out to the current difference. Essentially you're eliminating the 15-year carryforward limitation which eliminates the problem. Then, from a product development standpoint, you don't have anything to worry about. It's not going to affect the emergence of earnings. It's going to be very well-behaved.

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Unfortunately, there are a lot of companies that have already implemented SFAS No. 96. Obviously you've got to adopt SFAS No. 97 before you adopt SFAS No. 96. I think that you're treading a fine line. You don't want to be unprepared to adopt SFAS No. 96, but if you implement SFAS No. 96 in its current form and it's not promulgated, it's not the best of situations.

FROM THE FLOOR: SFAS No. 96 has been adopted. It's just the mandatory date that everyone has to go to that has been delayed?

MR. SMITH: That's true. But it seems pretty clear that whether it will be changed before everybody has to use it as an accounting method is open.

Now I'd like to talk a little about ROE and what I see as profit constraints being set by investors in the industry.

Return on equity is a profit measure that's used widely in other industries. It has not been used widely in the life insurance industry for a number of reasons, probably because we didn't have GAAP until the early 1970s and ROE on a statutory basis makes no sense at all. Return on equity is definitely a GAAP measure. Since the relatively recent adoption of GAAP by the insurance industry, the understanding of what this term means is probably not as advanced in the industry or by the industry analysts as it is in other industries. The reality is that the public markets, the analysts of life insurance companies outside the industry, those making buy and sell recommendations or invest/not invest recommendations look at a number of things. But ROE is a critical profit measure and you need to be familiar with it.

$$\text{ROE} = \text{GAAP Net Income} / \text{GAAP Equity}$$

There are lots of variations. Possible variations including 1) after-tax versus pre-tax, 2) deferred tax liability included/excluded, and 3) GAAP equity at the beginning of the year, end of year, or average.

A question is whether you look at after-tax or pre-tax net GAAP income. The analysts look at after-tax. Some companies look at pre-tax. Whether you include the deferred tax liability or exclude it in your calculation of equity and net income differs from industry to industry. For instance, the oil and gas industry typically excludes the deferred tax liability in their calculation. They feel like it's a distortion. This was way before SFAS No. 96, and I'm not sure I understand the reasoning there. But the reality is, once you've adopted a methodology as long as you're consistent, you're not going to affect it too much. Then there's the question of whether you're looking at income divided by equity at the beginning of the year, at the end of the year or the average. Everybody's got their own preference. Personally, I like to look at equity in the beginning of the year, but a lot of companies look at the average.

The hurdle rate is bandied about a lot. Basically, the hurdle rate is the minimum ROI acceptable given the cost of capital. I'm criticized a lot for using this term when we're trying to set profit objectives because they say you aren't taking into account the risk associated with the product you're developing. But the reality is I am if my cost of capital is reflecting the risk associated with what the cost of capital is being used to support. I agree 100% that your hurdle rate should reflect the risk associated with the product, but I believe that this definition does cover that.

$$\text{Hurdle Rate} = E / PE + (1-t) * (1-E) * C$$

Where: E is equity as a percentage of debt plus equity

PE is the price earnings ratio

t is the tax rate

C is the cost of debt

The hurdle rate is calculated mathematically as equity as a percentage of debt plus equity divided by the price earnings ratio plus one minus your tax rate times one minus equity as a percentage of debt plus equity times cost of debt. Basically you've got a hurdle rate that is a weighted average cost of debt plus equity. The ROE required is your price earnings ratio and the return on debt required is the after-tax cost of debt. It's much easier if you translate the price earnings ratio into what it is, which is earnings as a percentage of price. Let's look at an example:

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$$\begin{aligned}
 E &= 30\% \\
 PE &= 6 \\
 T &= 34\% \\
 C &= 12\% \\
 \text{Hurdle Rate} &= .30 / 6 + (1 - .34) * (1 - .30) * .12 = 10.5\%
 \end{aligned}$$

Equity as a percentage of debt plus equity is 30% which means debt is 70%. The price earnings ratio is 6 meaning that earnings as a percentage of price are approximately 16% so your stockholders are demanding 16% on the investment. The tax rate is 34% and the cost of debt is 12%. Your hurdle rate in this example would be your percentage of equity divided by 6 (essentially 30% of your capital is costing you 16.6% a year) plus one minus your tax rate times one minus your equity as a percentage of debt plus equity (the percentage of debt) times your pre-tax cost of debt which is 12%. Your hurdle rate in this example is 10.5%

I've done a lot of work in the past couple of years on leveraged buyouts (LBO) of life insurance companies and I thought this group would find it instructive to see what outside investors of life insurance companies (typically LBO funds) and private investors are demanding. I think it is instructive because the reality is that although we can try to define a theoretical risk return tradeoff curve and analyze associated risks and come up with what we think the theoretical hurdle rate is, the reality is there's a market out there that's defining the hurdle rate. As LBO funds become a larger and larger investor in life insurance companies and other companies, I think they're helping to define that. Nonetheless, even if they aren't, their thought processes give some sort of insight into what the appropriate hurdle rate is.

LEVERAGED BUYOUT (LBO) CAPITAL STRUCTURE

	<u>% of Purchase Price</u>	<u>After-Tax Return</u>
Senior Debt	70%	8%
Mezzanine Financing	20%	30%
Equity	10%	40%
TOTAL		15.6%

Typically, in an LBO, the capital structure is something like this: 70% senior debt or bank financing which is typically at prime plus x (x being 1 to 2). In this example, I'm assuming my cost of senior debt is essentially 12% and my after-tax cost of senior debt is 8%. My mezzanine financing generally comprises around 20% of capital. Mezzanine financing means either sub-debt, if there's a market, or preferred stock and sub-debt or sub-debt with warrants. That, surprisingly enough, is typically the after-tax return demanded by investors and that piece is running around 30%. You can think of that as a combination of a 14% or 15% coupon, typically 14%, because that's basically what's deductible if you had a payment in kind or a non-coupon paying debt for a period of time, which would be tax affected, and the rest is in convertible preferred stock such that your return on the conversion is anticipated to be around 30%. Your equity investors are demanding 40%. You take this weighted average and what you're going to get is 15.6%, which actually is very consistent with the idea that we should have a 15% ROI when we're pricing the products. My premise has been that 15% is too low, and I think that that's been validated by what we're seeing in the market because we're seeing the senior debt go down. The senior debt might be 55-65% and the mezzanine financing is going up. What we're going to see here is a 16-17% hurdle rate.

To take it even another step further, when you look at an analysis of a life insurance company, typically we're valuing the existing in force at a discount rate and then we're taking capital and surplus in dollar for dollar. The implication is that you're just earning investment income on the capital and surplus so that you're earning *i* on the capital and surplus. In order for it to discount back on a dollar-for-dollar basis, you have to discount it at *i*. The reality is you're only earning *i* minus your tax rate so if you're earning 9% maybe you're only earning 6.6% after tax. You're assuming the inherent discount rate in capital and surplus is 6.6%. If we're saying that the total company (this is the total company debt structure) has to yield 17% and the capital and surplus, which might represent anywhere from 20-50% of the total purchase on any deal, is earning 6% or 7%, the implications are that the existing business is being discounted at a much higher rate, maybe 21-23%. I think that's consistent with the prices we're seeing for the companies that are being sold today. The discount rate being applied to a stream of earnings is very high.

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The reality is that the manufacture of products is viewed as being substantially more expensive than the purchase of existing business. The companies are going in and buying universal life products that were produced over the last three years at commission rates of 80-115%. The company paid that as a percentage of premium and as a percentage of annualized premium in force two years later after presumably the high lapses have gone off which accentuates the problem. The purchase price of those in the market is 60-70%. So the market is viewing the profitability of the products substantially different than the life insurance companies that are manufacturing them are and presumably substantially different than the actuaries who are doing the product development. I'm not advocating that you go back to your company and price your products as if you were going to sell your company tomorrow. I am advocating to do that type of analysis to see if, in fact, new sales today are adding to the value of your company as perceived in the market tomorrow.

If you are not selling your company and if you are a publicly traded company, the same market that's buying your company in these types of deals is valuing your company in the stock market. They aren't doing this intricate of an analysis, but if they did, this is where they would go. If you're using a hurdle rate of 10.5%, which is obviously ridiculous, it's too low. I've had companies tell me that their hurdle rate is in the 12-13% range. I can't believe it based on the cost of capital, and I don't believe it given the capital markets today. The reality is I don't believe you can get mezzanine financing at 30%. I think that the reality is that mezzanine financing or sub-debt financing is not really available. If you view this as a three-step tier where the lesser risk is up at the top, this less risky step has contracted and is now at the 55-60% level. The next step has contracted a little bit or maybe it stays at 20% but there's no one willing to do it. The equity wants to do it if it can get the mezzanine financing and if it can get the sub-debt back up. So the overall effect is an increase in the required ROE and I definitely think that it has a major impact to the business that you're selling. Right now, when we're analyzing the profitability of new business (unless the company is obviously in a niche market) there are very few companies that are producing business that yields a return on their investment in excess of what our hurdle rate is. In a lot of cases there will be no value assigned to new business. It's frightening, but that's the reality.

FROM THE FLOOR: How is the inherent risk in the product implied in the hurdle rate?

MR. SMITH: The inherent risk of the product in this particular example is reflected in the return required by the investor. So that this 30% is not a set 30%. It might be 35% for one deal and 25% for another deal or 45% for another. It differs. Your price earnings ratio here is 6, but in a more risky deal your price earnings ratio might be 3. Your cost of capital is 12%, but in a more risky deal your cost of capital could be 18%. It's a market perception.

The use of ROE/ROI as a profit measure/objective implies that capital is a limited resource. This is critical. I've had two large companies tell me that they are using ROI and that they have a profit objective of ROI and they feel they have been hitting it at the 17-19% level, but their ROE is not 17% or 19%. There are a lot of things that affect the ROE. In these two companies what they were doing was using ROI as their profit objective and it was inappropriate because both of these companies were substantially overcapitalized. They had a lot of capital relative to their level of production. What they needed to do was dividend the money upstream, but they couldn't dividend the money upstream because they had a Phase III tax problem. Essentially they had a policyholder surplus issue so that if they dividend it upstream, they would be paying tax at 46%. Incrementally, they would never pay that tax.

The question they should have been asking themselves in the profit objective should not have been ROI. Return on investment implies that your limited resource is capital. They had plenty of capital. Their limited resource (what keeps you from producing unlimited profits) was limited marketing opportunities. What I think they should have been doing is pricing to maximize their limited marketing opportunities. One company was limited not by capital but by their data processing function. Their computer function just couldn't keep up; they couldn't administer it. What they were doing was incredible. They were pricing products on an ROI basis. They would go with a higher-level ROI product, but they weren't looking at the incremental level of computer time required to implement or administer that product or to bring that product on board. They should have been looking at something that had a lesser ROI (minimally lesser) but a substantially lesser data processing requirement. If they had used this they would have increased their total profitability and increased their ROI and increased their ROE. It has to do with using the wrong

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profit objective. There are a lot of companies blindly using ROI when, in fact, they are in the enviable position of not having limited capital. They have limited other resources. By definition, they have other limited resources. You have to identify what that limited resource is to maximize your profit per limited resource. Emergence of earnings/ROI will be affected by other things. Some of these are as follows:

1. Past and current accounting practices.
If you have been very aggressive in capitalizing expenses on various products, your ROE is going to be higher in the early years and lower in the later years. If your balance sheet is not heavily burdened by DAC or if you have been conservative, your earnings will be substantially better prospectively.
2. SFAS No. 97.
3. SFAS No. 96.
4. Target surplus requirements and surplus management.
Companies that have excess capital will have their ROEs pulled down. They are using maybe 10% of their excess capital to generate an ROI of 19-20% and the other 90% is earning 9% pre-tax and 6% after-tax, so their ROE is the weighted average (90% times 6 and 10% times 19). Their ROE is very low. The more target surplus business requires (target surplus invested at i ; i being 8%, 9%, 10% pre-tax), the higher your return on the base product has got to be if you're going to meet the 15-17% ROE, whatever your hurdle rate is determined to be.
5. Composition/size of existing block compared to new business.
This has to do with number 1, depending on whether you were conservative or aggressive in your past accounting practices. If new business is a drop in the bucket compared to old business, it doesn't really affect you that much. But right now, if new business is a substantial portion of the total size of the company, what you're doing now is going to affect your ROE greatly.

In conclusion, if you are the product development actuary and you are setting the pricing assumptions, particularly with SFAS No. 97, you should sit down with the valuation actuary because there's no margin for adverse deviation in your GAAP assumptions. You do not want him or her setting assumptions that are different than the way you priced for it. All you're going to do is subject yourself to unnecessary surprises. You should come to agreement with what the appropriate GAAP methodology is in advance. The valuation actuary should not set the assumption without discussing it with the pricing actuary and vice versa. If you don't, you're going to have a very frustrated CEO and he is probably going to be irritated with both of you.

The other thing you want to do is to set up a company projection, a model office type system where you can test what the incremental effect of offering this product is going to do to your company ROE. It gives you a map to follow prospectively in your process. I don't think it is inherently obvious or intuitive to see what the effect of offering this product or that product will be, particularly when you've got different products being subjected to different accounting standards. It was much easier when GAAP earnings emerged as a level percentage of premium. It's much more difficult today.

FROM THE FLOOR: Can you help me figure out what relationship should or ought to exist between ROE and ROI? What's the linkage between the two?

MR. SMITH: There's a definite linkage between the two. I don't think that I'm really going to be able to explain it here. What I would refer you to is Dave Becker's article on that relationship which was just recently published in the *TSA*. I had written an article in the *TSA* that explains the relationship between ROI and ROE in 1987. Don Sondergeld wrote a similar-type article back in 1979. I'd refer you to those because those three articles will really address that question and I don't think I could do justice to the topic here.

FROM THE FLOOR: Getting back to SFAS No. 97, if you have a fixed premium universal life with a level percentage of premium load, is that considered a front-end load?

MR. SMITH: No. That's not a front-end load, not the way I use the terminology here.

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FROM THE FLOOR: Under SFAS No. 97, are the riders and the COIs of the riders considered in your gross profit stream when you are accounting for universal life?

MR. SMITH: Yes. It's not addressed directly by SFAS No. 97, but I would maintain yes and what we've done is definitely reflect that.

FROM THE FLOOR: Should first-year reinsurance allowances be considered first-year unearned revenues?

MR. SMITH: That's a good question. Are we talking about 100% allowances on COIs or are we talking about 100% allowance on target premiums?

FROM THE FLOOR: COIs.

MR. SMITH: I haven't really thought about it. Let me think about it and give you my opinion on it later. It probably is an unearned revenue liability, but I'm not sure how it would fall out. It's clear you can't just decrease your DAC. They want dollar-for-dollar capitalized expense. They want a full balance sheet treatment. I'm not sure whether it should necessarily affect your gross profit stream. I think the answer is yes, but it clearly should not be offset. You should not have pure offsets in the balance sheet.