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MUTUAL COMPANY GAAP

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- What are the objectives of mutual company GAAP?
- What are the common features seen today?
- Comparisons to stock company GAAP
- How have GAAP statements affected management of mutual companies?
- Alternate minimum tax

MR. KRISS CLONINGER III: Our panelists intend to discuss the various uses and abuses of GAAP for mutuals. They'll also talk about where they expect companies to go from here.

Your first speaker will be Mike Tuohy. Mike is a principal in the New York office of Tillinghast, Towers/Perrin. He is a Fellow of the Institute of Actuaries, an Associate of the Society of Actuaries, and is in charge of the worldwide life insurance practice of Tillinghast.

Bob Stein will follow Mike. Bob is an FSA and a CPA and is a partner in the New York office of Ernst & Young. Bob is the National Director of Actuarial Services for his firm. Bob is also a newly elected Board Member of the Society. As an aside, I would like to tell Bob and the other Board Members that I think this is the best Society meeting I have attended in many years, and I hope that they will consider this meeting as a standard of excellence toward which we should strive in the future.

Our last speaker will be Ed Robbins. Ed is an FSA and a principal in the Chicago office of KPMG Peat Marwick. Ed served on the Program Committee for this meeting and therefore deserves some of the credit for helping organize it.

I am Kriss Cloninger, a principal in KPMG Peat Marwick. I live in Atlanta, the host city for the 1996 Summer Olympics. After the presentations, we will take questions or comments from the floor. Now we'll hear from our first speaker.

MR. MICHAEL R. TUOHY: The topic is mutual company GAAP, and let's just spend a minute defining that. Mutual company GAAP covers the whole spectrum from slavishly following stock company GAAP all the way to value-added techniques of scorekeeping. I'm going to split my session into two bits. One will deal with the various merits and demerits of slavishly following stock company GAAP rather than using some sort of value-added approach. The second will address the thorny problem of how you treat policyholders' dividends.

When a mutual company steps up to calculate adjusted earnings, the approach it should take depends on what it wants to achieve. If it wants to be able to deliver to its board an auditable set of accounts that use publicly accepted standards, or if it is looking to compare its earnings to a stock company, then a slavish use of stock company GAAP would be appropriate. However, if the purpose is to have a good, hard look at itself and get a meaningful measure of performance, then I would argue that slavishly following stock company GAAP is not a very meaningful measure of management's current performance and a value-added approach to scorekeeping will give a much better measure. When mutual companies decide to establish a new measurement system, they have an opportunity that shouldn't be wasted. If the company does want a meaningful performance measure that will assist in the management of its business, it should go back to first principles and set out what the objectives are it's trying to achieve and then set up a measurement system to see if those objectives are being achieved. One of the most important objectives that a life company, whether mutual or stock, should be striving to achieve is getting a reasonable rate of return on the amount of money it invests in its new business. For a mutual company to stay as an ongoing entity, it must achieve a rate of return in the long term on its amount invested in new business that exceeds its rate of growth. Given the rapidly increasing fixed costs a company has to incur particularly in the area of technology, a company's growth must be significantly greater than inflation to keep expense ratios at current levels. This suggests a double-digit growth requirement leading to a double-digit rate of return requirement. I argue for a measurement system that reflects this requirement.

Let me briefly, describe a value-added measurement system and define some terminology. Basically I'm defining value added as the increase in embedded value where embedded value equals the market value of assets matching free surplus plus the value of in-force business. Again, I need some more definitions.

First of all, let's define assets matching free surplus. Divide the liability side of the balance sheet into surplus and liabilities and then split the surplus between required surplus and free surplus. In determining the level of required surplus, one can get very theoretical and say, I want enough required surplus to give me an X% probability of going belly up. Or one can be a bit more pragmatic and ask, how much do I need to get a Moody's triple-A rating, or a Best's A-plus rating? However one gets at it, there is an element of surplus that is required to carry on business. Only surplus over and above that amount is free and distributable. Assets should be allocated to match the various elements of surplus and liabilities. Then the market value of the assets matching free surplus is the free asset value.

Moving on to value of in-force business, this is defined as the present value of future distributable earnings, discounted at an appropriate rate using current best estimate going-concern assumptions. What is the appropriate discount rate? Overall, this rate should be the company's required rate of return, which I will refer to as the hurdle rate. You might want to vary the rate by line of business depending on the risk involved in each line of business.

What are distributable earnings? They're after-tax statutory earnings less the increase in required surplus. Included in the after-tax statutory earnings is after-tax investment

income on assets matching the required surplus. The key management information is not the amount of embedded value in isolation but the amount it increases or decreases over time and the reason for such movements. This gives much more meaningful information as to recent performance than does stock company GAAP earnings for the following reasons:

1. Assumptions are set using best estimate assumptions. Analysis of actual experience against assumed is much more useful when the assumptions are best estimates rather than historic assumptions that have an element of conservatism.

2. The discount rate equals the company's hurdle rate rather than the lower assumed earned rate.

3. The value added by new business is isolated. Senior management can see whether the company's new business efforts have added or perhaps subtracted value. Also the measurement system directly links to the company's pricing. I find so many companies that very religiously price to achieve a certain hurdle rate of return but no follow-up analysis takes place once the business is put on the books.

4. Required surplus is reflected in the calculations. The importance of recognizing required surplus has only come to the fore over the last five years as companies have become more and more conscious of the importance attached to it by the rating agencies.

Whatever method of scorekeeping one uses -- value-added or even stock company GAAP -- when looking at a mutual company, one does have a problem with the treatment of policyholder dividends. As you all know, some elements of a policyholder dividend are just straight return of premium or premium load built into the product; whereas some of the dividend could come from superior performance. To the extent that a company performs superiorly, should one penalize the company's scorecard because it pays its owners a dividend reflecting performance? If one does penalize the company's scorecard, this is equivalent to measuring a stock company on its earnings net of dividends to stock-holders, which is generally not done. Earnings of stock companies are looked at before they pay dividends to stockholders.

I'm going to take you through an approach where I try to break the performance of the company into three elements -- investments, sales, and operations -- and try to get at the value added by each of these elements of the company.

First of all, let's have a look at value added by investing. I would select an index or combination of indexes against which the investment performance will be measured. The indexes would be defined both in respect of term and quality of assets. How would you derive these indexes? That might be a subject for a whole presentation, but the approach would be to use multiple scenario testing and efficient frontier techniques to see what term and quality of assets is most appropriate for the degree of risk that the particular company is prepared to take.

At the same time, one would also define some constraints for one's investment department. For instance, if the bond index was a five-year duration, A-rated bond, you may set a constraint on the investment department to go no shorter than three years in duration, no longer than eight years in duration, and no worse quality than triple B. The constraints would also be derived from the scenario testing reflecting the risk tolerance of the company. The more risk averse the company, the narrower the constraints. The more risk taking the company, the wider the constraints.

The value added by the investment department is the actual increase in market value of assets minus actual investment expenses incurred, less the increase in market value if one had just invested in the index minus the investment expenses one would have incurred if all one had done was invest in the index.

One does need to dollar weight the comparison; in other words, the timing and amount of the investments in the index should coincide with the timing and amount of investable proceeds received by the investment department.

In value added by sales you return to the concept of discounting projected distributable earnings from the business sold during the year at the company's hurdle rate. What assumptions would be used? I would use the dividend scale that was used in sales illustrations, and I would use the yield from the index or indexes used in the measurement tool for my investment department. I would use actual acquisition expenses and best estimates for maintenance expenses, persistency, and mortality.

Last, we have value added by operations. Here I regard the operations as adding value if they achieve superior mortality, superior persistency, and/or superior maintenance expenses. How does one define superior? Ideally this would be performing better than one's peers. However, this method of measurement may not be practical, and one may have to measure against previous company experience.

I would look at this in a value-added type of way -- first of all, calculating the value of the in-force business at the beginning of the year, again using the current dividend scale, the yield from the index, and best estimates of maintenance expense, persistency, and mortality. Then I would project this forward one year, project the distributable earnings and the value of the business projected at the end of the year, assuming no change in dividends, the index yield, and the standard performance measurements of mortality, persistency, and maintenance expenses.

We would then have expected distributable earnings for the year and the expected value of the in-force business at the end of the year. Then I would analyze the actual performance during the year and recalculate the distributable earnings and the value at the end of the year, inputting the actual maintenance expenses, persistency, and mortality. The difference between the actual and expected would be the value added by operations.

This process attempts to answer the question, has management added value during the year? First of all, has the investment department outperformed the index, taking into account its expenses? Has the sales area added value by getting a rate of return in excess of the hurdle rate on its new business? Have operations performed above

standard as far as mortality, persistency, and maintenance expenses are concerned? In this way, you have avoided the problem of deducting dividends or not deducting dividends when coming up with an income statement. Of course, value added does not have the nice neatness of a GAAP earning statement, but I think it does dig into more what the company is all about.

Before I close, I want to return to one point, regarding stock company GAAP. I really believe its major shortcoming, and a very serious shortcoming, is that the profitability of new business is only minimally reflected in earnings in the year of issue. This is not logical when as much as 75% of the company's effort and expenditure is involved in developing that new business. This has resulted in senior management receiving inadequate information as to the profitability of its new business due to the focus on the GAAP bottom line. The current state of unprofitable individual life business in this country has crept up on managements rather than having hit them between the eyes when it first started.

I believe that significant new business value has been subtracted during the 1980s. I have no good, solid research other than client experience and also general chatter around the market, but low returns have been achieved on investment in new individual life business during 1985-89 and you hear numbers anywhere from 6-10%. If the industry average was 8%, what then? During the period of 1985-89, new annual premiums of $56 billion were written in the United States. If companies were only achieving 8% on the amount invested in new business, then the industry has a subtracted value of the order of $22 billion, if one uses a 15% hurdle rate or $14 billion using 12%.

These are substantial numbers. It doesn't compare with the savings and loans obviously, but shows a large erosion of the industry's embedded value. I believe this number would have been significantly reduced had scorekeeping methods given appropriate emphasis to the value being subtracted by new business sales.

MR. ROBERT W. STEIN: I think Mike has focused on some of the specific methodologies that companies have either adopted or that are suggested to be adopted. I'd like to go beyond that for a little while and talk about some of the uses of the information that companies are developing, the kinds of information that should be developed and how it should be used, and focus on perhaps some of the shortcomings of some of the systems in use.

The comments that I'll make will be based on working with probably 25-30 mutual companies to adopt management reporting systems, so there is a fair body of actual data there. There has been, as that indicates, a tremendous effort in the mutual segment of the industry and, in fact, including the fraternal segment of the industry, over the last few years to develop some kind of nonstatutory, be it called GAAP or some kind of modified GAAP, financial reporting systems. I'd emphasize the reporting aspect of it. There has been less development of full-blown management systems, and that's really what I'd like to talk about.

Some mutual companies have been monitoring nonstatutory performance measures for a good many years. I think the bulk of the effort, though, goes back into the early 1980s,

not much beyond that, but the scope of the effort among the industry has been really quite impressive. There has been a tremendous amount of activity. There are not too many sources of public data with respect to what has been done, but there have been two sources that have been generally available in some settings.

The first is a survey that was done in conjunction with the June 1990 Society meeting in San Francisco, wherein 44 companies responded to questions concerning the nature and the results of their GAAP processes, if you will. The other is a financial management survey group that Ernst & Young runs and has about 35 companies participating in. It was formed about four years ago for the purpose of anonymously sharing information on practices in the mutual segment of the industry and line-of-business financial results.

Both those sources of information on the efforts being made by mutual companies indicate that among the large companies, companies of the $5 billion range or higher, the number that are actively involved in routinely preparing management financial information is really extraordinary. Well in excess of 80% of large companies are doing routine, meaning quarterly, kinds of reporting. There's a fair degree less enthusiasm for nonstatutory financial reporting among the smaller companies, but even there the level of effort approaches 50% of the companies in the mutual and fraternal segment.

I think we continue to see large companies refine and enhance their methodologies and extend them into the financial management process, which is something that I'll be talking about. The small companies are continuing, perhaps ever so slowly, to adopt financial management methodologies that follow some form of defined, nonstatutory accounting.

Though there's been a lot of activity, I'd be inclined to say that this means the process of managing by nonstatutory information within the mutual segment is here to stay, but I'm not so sure that's the case. I think there are some very serious challenges that have yet to be met in the development and utilization of nonstatutory information, and I truly believe that, depending upon how the industry responds to those challenges, the improved financial management methodologies of which nonstatutory GAAP reporting is only one part, may or may not take hold.

My concern is that the financial information being prepared is really not being integrated into a comprehensive financial management approach to managing financial results. I'm making a distinction repeatedly here between the reporting of financial results and the use of that information to manage results. I think we see a lot of reporting going on, and even now while the industry has been working hard for seven to eight years on this kind of project, we see less real management of financial results. Management is not effectively using the capability that it has developed and, as a result, the benefits that could accrue to companies that effectively use this kind of information are really not being realized. As I say, I think the heart of my concern is that we've developed a sophisticated reporting process, a time-consuming reporting process, and have yet really to make the transition into the utilization of that data in a real, honest-to-goodness financial management process. I think the level of effort being devoted is just too strong. Too much time and money are being spent to not take the next logical step and to use the information more aggressively.

There is certainly a good reason for doing that. Obviously any financial management system has to be able to measure performance and report on it; but more important, a well-designed, integrated or comprehensive financial management system would really help identify the causes for performance. It will lead management, both at the senior levels and at the operating levels, down into the organization so that they can identify the sources of good performance, the sources of bad performance, and provide a mechanism or a structure to evaluate alternative actions for dealing with the problems.

In the end, in my mind, any financial management system that's worth anything is only good to the extent that it provides actionable information to management. A system that concentrates on reporting results and really doesn't go beyond that is not worth the effort, and I think we need to move beyond the reporting of results that we see so frequently now.

I think if the performance of the mutual industry was at a higher level, if you will, I could understand some of the casual attitude toward developing an integrated financial management process. Unfortunately, the results indicate that both on the stock and the mutual company side, performance is clearly not where it ought to be. Here we do have some actual data. Certainly the stock industry, as you're perhaps well aware, has continually suffered a reduction in performance during the last decade. The 1980s started with the stock companies experiencing returns on equity of about 14%. There's been a continual slide throughout the 1980s to a point where the industry measures now are around the 9% level. There has been some slowdown in the rate of decrease, if you will; but nonetheless, a third of the performance of the industry has been lopped off during the last decade.

I think the mutual segment has experienced a similar phenomenon. Data is not available for the full decade of the 1980s. Most companies did not go back and restate that far back; but in the brief period from 1985-88, financial performance, as measured by return on equity for the mutual and fraternal segment of the industry, appears to have declined also by about a third. The absolute levels are substantially lower in the first place than in the stock segment, and the performance is continually weaker. There has been some upturn, as measured by the financial bases that companies used in the mutual segment in 1989, and we're looking for some improvement in 1990. Nonetheless, there still remains plenty of room for improvement in the financial management of mutual insurers.

In fact, I think if the mutual segment is to survive, it's got to do something to strengthen its capital base, and the only way to do that, obviously, is to more aggressively improve the financial performance of the organizations in the mutual segment. This regard is really the heart of my concern and I believe quite firmly that the sound use of properly designed, comprehensive financial management systems will provide the information and can be a real critical element to allowing management to develop that kind of information that it really can use and make decisions on, so it can drive the financial performance of the industry forward. I'm not going to focus on the technical aspects of developing GAAP for mutual companies, but I'd like to focus on three areas of the financial management process that I think are missing sorely from many of the financial

management procedures that mutuals use. In fact, some of these comments would be equally appropriate for stock companies.

The first major problem is the manner in which capital is allocated to businesses for the financial performance measurement process. I think there's a near unanimity as to what the most desirable means of allocating capital to the product lines or the business units are, and those processes normally start with the concept of associating target surplus or required surplus with business units or lines of business. This would be how ever you might carve up your organization for management purposes. Unfortunately, that means in order to get accurate and reliable results on the performance of specific businesses, some of the emotional issues dealing with the distribution of surplus that the lines of business have accumulated historically have to be dealt with. We've got to get to a system where more companies literally deal with the issue of capital commitments to line of business and report and actually manage that way.

Right now among the 30-40 companies that are actively involved in developing financial information on a nonstatutory basis, while they recognize the issue, barely half of them take the final step and literally do the reporting and set up the management process so that you can develop useful information. The failure to address this capital allocation issue head on obviously causes severe problems in evaluating line-of-business performance and prevents any ability to compare financial results of business units with organizational financial objectives or with financial objectives that are established for each line of business.

I think before we can really deal with line-of-business performance issues and get at the root cause of the performance problems, we're going to have to, as an industry, take the difficult emotional step of really allocating surplus to lines of business.

The second area that I'd like to briefly mention was one that Mike alluded to earlier and that is the strong need to get the pricing processes more closely linked with the financial reporting methodologies being used. We've got to really move forward as a profession, I believe, and again, I address the difficult issue of developing more coordinated pricing methodologies with respect to organizational and business unit financial objectives. Now, this doesn't mean that all lines of business and all products have to be priced and managed on the same financial standard. It doesn't mean that you have to use return on equity. What it really does mean, though, is that you have to create linkages between the enterprise financial objectives and the business unit financial objectives so that, when we enter into the pricing process and as the pricing process reflects decisions to improve financial results, we have some consistent ability to monitor performance with respect to preestablished standards.

I think right now there is a very big gulf between pricing methodology and basic financial performance strategies. So we really need to move forward as a profession to establish stronger linkages between the goal-setting processes in terms of financial objectives for lines and for the organization in the pricing processes. This coordination has to take the form of the measurement standards in use; that is, it's desirable to measure results on the same basis that we price for, so that when we price for a given level of

performance, however that is measured, we have some ability to compare actual results with pricing anticipations. Also, the sought after level of performance needs to be reflected.

As simple as those two very basic links sound, we see continually too many cases where the pricing process is being done in a vacuum, totally independent of the basic financial orientation of the company. I think we've got to move forward as a profession and develop a more fully coordinated approach to pricing products, a system that really reflects the organizational and the business unit financial objectives. I think only at that time will we really close the gap in terms of attempting to improve performance and to move it toward the level of financial results that the organization is looking for.

Finally, I'd like to touch on one area that probably goes well beyond the traditional actuarial role. It's an area that I have spent a good deal of time on during the last several years as companies have tried to move the financial reporting processes into a management setting. I think also the reason I mention it is not only because of its importance, but also because I believe it's a good indication of the kinds of things that actuaries need to get involved in beyond their traditional role, and that's the need for these GAAP systems or these financial reporting systems to become truly integrated with cost management systems and productivity and quality improvement programs.

I think that's at the heart of many companies' problems and performance these days, and I think the reporting systems that are being talked about here really need to be developed on a more coordinated basis with those cost and quality programs. I think it's clear that management has a significant need for information in this regard, and it's also clear that the financial systems that are presently in place in most companies just do not provide the kind of cost, productivity, and quality information that really allows management to make decisions and move to improve results.

Modern cost-reporting techniques coupled with state-of-the-art quality and productivity assessment programs, I believe and we have seen in practice, will provide management with the information it needs to really understand the full cost of products and services that it offers, in many cases, for the very first time. I think these techniques and programs will allow management to appreciate the source of product cost in an organization, and they will allow management to understand the relationship between the user of services and the cost of those services. They will allow management to really, again, in many cases for the first time, understand what influences cost, what the cost drivers are in an organization, and what controls cost levels throughout a company.

On the productivity and quality side, you've obviously heard a lot about quality in the general industry setting and the general economy. It's equally true, if not more so, with respect to financial services and the insurance industry. The kind of productivity and quality programs that can be implemented, that require a fair amount of monitoring, link very nicely to cost management programs and to the kind of financial reporting that we're talking about.

These kinds of productivity and quality assessment efforts allow management to measure the effectiveness of business operations conducted throughout the organization and

provide a means of measuring the quality of the organization, the quality of its business activities, and the productivity of its work force. I think that's the kind of thing that can be integrated into these financial management systems in a broad brush approach and can allow management to focus on some of the fundamentals of the business that it is in; again with the effort being to make decisions, to be able to move forward, and to really manage financial results.

You might wonder why actuaries should be involved in processes like these that seem to go well beyond the traditional actuarial role. I think there are at least two good reasons. The first is that actuaries really do need much better pricing information. The unbundling of products, the offering of specific product features and services at separately identifiable prices, means, in my mind, that actuaries have to develop a better understanding of the fundamental cost structure of their businesses.

I think for too long the actuarial profession has relied on relatively generalized unit cost data without getting at the heart of the structural issues that most companies face in the expense area. So I think for our own self-interest in terms of effectively pricing products, we need to move forward in some of these cost-management and cost-information areas.

The second reason I think actuaries need to become involved in efforts like the cost system and the quality and productivity efforts could be said about all aspects of financial management processes in stock companies or in mutual companies. It's a point on which I'll close. Actuaries clearly have to go well beyond their traditional roles in the financial management process. Historically, it appears that actuaries have been dealing in the pricing process often in the abstract, often without proper connections to the rest of the financial organization, and have been too caught up in the nuances of reporting results.

I think we need to have the actuarial profession stand up and become more active in the financial management process and take more responsibility for the profitability of products, not only in the arcane world of product pricing, but also once those products are offered, once the performance of those products are measured out in the market place. I think we've got to participate more in the search for solutions to the performance problems of the industry.

We have done a good job in this financial management process of developing better tools to measure results, and now I'm a firm believer in the fact that the profession has to move forward and play a significant, if not leading role in really integrating the reporting that's going on into more full-blown financial management performance improvement processes.

MR. EDWARD L. ROBBINS: I'd like to cover those areas where calculating taxable income involves GAAP-like processes. Kriss wanted me to make you all aware that a lot of the GAAP modeling that you're doing, maybe 90% or 95% of it, is already done for the purposes of alternative minimum tax, at least through 1990 for large companies. Most of you know that there has been a tremendous upheaval recently on GAAP-like taxable income issues.

There's an old Chinese curse saying "May you live in interesting times." I think we're living in those kinds of times. I'm going to cover some information on alternative minimum tax and then wrap up with a synthesis of material that I received on the version of the new tax law that passed the House on October 16, 1990, and the version in the Senate package to be voted on shortly.

The three areas I want to discuss are (1) adjusted current earnings under alternative minimum tax, even though that may be going out shortly; (2) reinsurance GAAP-like issues (Just to give you an advance warning, the Colonial American type of impact may be going out on ceding commissions incurred from September 30, 1990 on; but the part of the reinsurance issue that's still quite relevant to everyone here is ceding commissions with an option to amortize them on gross profit streams. That piece is going to continue to be relevant); and (3) as a wrap up, the latest Senate versions of add-ons to regular taxable income, what we call the proxy capitalizations.

The first item, deferred acquisition cost calculations under adjusted current earnings, has been in existence since the 1986 Tax Act and its days appear to be numbered. At this point, regular taxable income is up in the air, and we will know in a month or two how important this first issue is. One thing for certain is the basic formulas for alternative minimum tax have not changed. There is no change contemplated in any current legislation on the basic structure of alternative minimum tax.

Since alternative minimum tax is being hard coded into the law, let's take a moment on it. You have to compute a tentative minimum tax. You compare this tentative minimum tax to your regular tax and pay an alternative minimum tax if the tentative minimum tax is greater. The formula for tentative minimum tax is 20% of what is called alternative minimum taxable income. Alternative minimum taxable income is regular taxable income plus certain 100% preferences, plus 75% of what our tax insurance brethren call the add back. Twenty percent of all that is your tentative minimum tax.

For life insurance companies, basically the only relevant item that ends up in those 100% preferences is private-activity tax-exempt bond income, which is a bit of a rarity now -- the San Diego Stadium, for example. Consequently, alternative minimum tax is basically an interpolation of 25% regular taxable income plus 75% of adjusted current earnings.

Adjusted current earnings are intuitively, from an actuarial viewpoint, very easy to understand. They are close to what tax people call earnings and profits. The amount is determined as the sum of the cash flows plus the change in tax basis assets less the change in tax basis liabilities plus the change in deferred acquisition cost.

The other definition of adjusted current earnings is what you might call the tax people's definition of adjusted current earnings. You start with your regular taxable income and add back the company share of tax exempts and dividends received, any small company deduction, (a very significant number for small companies), and the change in deferred acquisition cost.

For practical purposes, adjusted current earnings is generally a lot worse than regular taxable income. It's designed to be what you might say is the worst of two worlds. It's

designed to be at least as broad a tax base as preadjustment alternative minimum taxable income. It's also designed to be at least as broad a tax base as GAAP income reported by public companies. There is a fairly large chance that what's happening now in the House and Senate will not become law. I don't know what that chance is, but many of you are having to deal with adjusted current earnings.

Basically, for an item to be deductible in adjusted current earnings, it must be deductible under both the earnings and profits rules, which has a separate tax meaning, and the rules for preadjustment alternative minimum taxable income, which is very close to regular taxable income. Enough about adjusted current earnings.

Let's get into deferred acquisition cost as measured from an adjusted current earnings point of view. Up until this point, we've been talking about hard-coded statutory language defining alternative minimum tax. Basically, you're talking 25% of regular taxable income plus 75% of adjusted current earnings. But now once you start to define deferred acquisition cost, you start getting somewhere out on thin ice.

The reason you're going out on thin ice is that the language describing the methodology for calculating deferred acquisition expense for adjusted current earnings purposes is ambiguous and subject to a number of possible interpretations. Now, that's very meaningful when you're talking in terms of a 15% marginal rate on your deferred acquisition cost increase if you are an alternative minimum taxable income taxpayer. You're talking meaningful dollars -- 15% marginal rates. You've got an ambiguous environment in which to calculate this. So it behooves you to take advantage of the ambiguities and to do what's best for the company.

Again, I'll just emphasize that if you already have GAAP models built, if your in force is stratified, you may just want to add a few more calculations and try different interpretations of the proposed law.

The second problem we have is that not everybody believes that the House committee reports of the 1989 Act that defined the language for deferred acquisition costs are controlling. There is a small, but rather important contingent that believes that the House committee report is not controlling, and that you must use published deferred acquisition costs. We believe that part of that small, but important contingency includes the Treasury.

Third, we don't know how long this current structure is going to survive. Let's take a look at what the House committee report language says. The first sentence has been in existence ever since the 1986 Act. It says to calculate your deferred acquisition costs just as if you were an audited GAAP company and as if such treatment were required for all prior taxable years. You're talking about a January 1, 1990 fresh start. Get your deferred acquisition costs for tax purposes up as high as possible because that will maximize deductions. Of course, you must be subject to any consistency provisions under normal GAAP on a going forward basis. Fortunately or unfortunately, you may not have to go that far forward any more.

Some new language was added by the House committee report on the 1989 Act which says that to the extent that life insurance reserves are relevant in determining the amortization schedule under generally accepted accounting principles, tax reserves, instead of GAAP reserves, should be used. What does this mean? I thought I knew what it meant when I read it, but by now there are about eight interpretations of what that wording means. I'll start out with what I thought it meant.

For FAS-60-type products, which are traditional products, the revenue base is premium income. Reserves are not relevant. Therefore, you would use your FAS 60 deferred acquisition cost methodology. For FAS 97 products, on the other hand, where the revenue base is gross profits, reserves are relevant. You can define gross profits the FAS 97 way as your sources of gross profit or, as most actuaries know, you can reconvert those gross profits into gross cash flows minus the increase in the benefit reserve. You get the same answer.

Once you convert to a gross cash flows minus an increase in benefit reserve approach, then you can easily add back your benefit reserve increase, deduct your tax reserve increase, and get an adjusted current earnings basis amortization pattern for your gross profit. Table 1 gives you an illustration of this.

This is a very simple-minded five-year single premium deferred annuity. The cash flows are on the left. For straightforwardness and simplicity, I'm assuming a zero interest rate and a 100% amortization ratio -- a zero profit/zero interest rate product. It's kind of like the guy gives you a thousand dollar deposit, he surrenders his thousand dollars at the end of five years, and he gives you a policy fee to put under your mattress instead of his mattress for five years.

You have your gross cash flows of a thousand dollar deposit, plus $30 of policy fee, in the first year. He pays you policy fees in years two through five, and he gets his thousand dollars back at the end of the fifth year. Your gross profit equals your cash flows, minus the increase in your benefit reserve, and you end up with a present value of gross profits of $140. Your acquisition expense also happens to be $140. You have a 100% amortization ratio. In the first year the deferred cost balance is $140 minus 100% of the $30 gross profit which equals $110. Then it amortizes from $110 at the end of the first year down to zero at the end of the fifth year as subsequent policy fees are collected.

Now let's just assume that you take the "to the extent reserves are relevant" language of the House committee report, and substitute the tax reserve increase in place of the GAAP reserve increase. What do you get? Well, you have a $920 tax reserve. You're adding $80 to your gross profit in your first year. Now you have $110 of adjusted current earnings gross profit. Thus you can justify amortizing 110/140 of your acquisition expense in the first year -- a tremendous improvement over amortizing only $30.

There are a couple of caveats. This is a simplistic example, of course, but it gives you a sense of the structure and certainly a sense of the direction that this approach takes you. Additionally, this example of zero interest and 100% amortization ratio gives you the

TABLE 1

Substitution of Reserve Method, Zero Interest, 100% Amort. Ratio

YR	Cash Flows	Incr. in Ben.	Gross Profit	Acquis. Expense	GAAP DPAC	Incr. Tax RS	ACE Profit	ACE DPAC	Add-back
1	1,030	1,000	30	140	110	920	110	30	30
2	35	0	35	0	75	0	35	-5	-35
3	30	0	30	0	45	0	30	-35	-30
4	25	0	25	0	20	0	25	-60	-25
5	-980	-1,000	20	0	0	-920	-60	0	60
Total			**140**	**140**			**140**		

same exact answer as making adjusted current earnings equal to GAAP income. In other words, for every dollar difference between the benefit reserve and the tax reserve, your deferred acquisition cost goes down dollar for dollar. Amortization is increased dollar for dollar. This is one interpretation.

The last item provides a small benefit for FAS-60-type traditional products. It makes the book unreported profits provision that existed in the alternative minimum tax section from 1987-89 consistent with the adjusted current earnings provision. Some companies feel that this would allow companies to go directly to a substitution of GAAP income method for adjusted current earnings on traditional product lines. Others feel that the first-year expense allowance on your life insurance products, for example, could be directly subtracted from your otherwise capitalizable expenses, and you amortize the net amount under GAAP assumptions. So if the commissioner's allowance is $7 per thousand and your actual capitalizable expenses are $12, you end up amortizing $5 under GAAP assumptions.

The Treasury came out with a notice of proposed rule making, Notice IA-29-89 in May 1990. As I said, to the eight interpretations that we have under the House committee report language, the Treasury has basically added a ninth. The Treasury has given us two safe harbors in the calculation of deferred acquisition cost. The first safe harbors is published deferred acquisition cost. You're allowed to use audited deferred acquisition cost. My reaction to that is thanks a lot. It doesn't really help. It's a rather bad answer.

The second safe harbor the Treasury provides is to use what it calls gross premiums plus gross investment income. Where did it get that from? I don't know. I suspect where the Treasury got that from is it picked up a statutory annual statement blank, turned to page four, the summary of operations, and saw gross premiums and gross investment income at the top half of the page, and figured that's got to be gross profit. I don't know.

It's interesting what the thinking is because not very much later Revenue Proc. 9036 came out, which basically tells you how to amortize ceding commissions under the Colonial American decision, and the Treasury has the same formula in that: gross premiums plus gross investment income. Somebody seems to have the idea that it's the amount of the revenue base rather than its incidence that determines the deferred acquisition cost amortization pattern. So there's some fairly fuzzy thinking going on, and of course, it's subject to an awful lot of conjecture as to how controlling it is. It is a proposed rule making, meaning that it does not constitute substantial authority, even though the Treasury says in that proposed rule making that you can rely on these safe harbors. There's a real legal contradiction there. You can rely on something that you're not allowed to rely on.

There are hearings on that proposed rule making that have taken place supposedly at the Treasury for those who are interested in this. Comments are being specifically invited on five issues. Number one, what expenses are properly deferrable? That's a good question. As you know, there's really no recipe for it. GAAP companies have been struggling with this issue for years.

The second question is whether amortization schedules for adjusted current earnings purposes should be based on gross premiums or net profits. That's a bad question. The Treasury is ignoring GAAP. It's ignoring the statute. It's ignoring the House committee reports.

Third, the Treasury is inviting questions on the length of the amortization period. What it talks about is the useful life of a product for purposes of deferred acquisition cost amortization.

Fourth, a very important issue, what is the appropriate treatment of policy acquisition expenses when transactions are reported differently for tax and financial reporting purposes? What is the Treasury talking about? It is talking about purchase accounting, assumption reinsurance, possibly indemnity reinsurance. What should we do? In the main body of the proposed rule making, the Treasury has the caption, and the text simply says "reserved." The Treasury is waiting to fill it in. It doesn't have answers at this time.

The fifth question the Treasury is inviting commentary on is whether reserve deductions should be taken into account in determining appropriate amortization schedules. What the in group tells me that means is whether to believe the House committee report language or not.

Now to the latest news out of the Congressional budget hearings. The trouble with agreeing to be a panelist on a subject like this is that you can't prepare everything in advance. You're trying to hit a moving target, and you call your contacts the night before you're supposed to go on before the audience. As the old Chinese curse said, "May you live in interesting times." It's kind of like the old actuarial curse, "May you have stupid competitors." Anyway, I've tried to be as up-to-date as possible.

Let me deal with the main issue that we're talking about -- September 30, 1990. Basically, that is the effective date should some compromise version of the House and Senate packages pass. They're talking about a proxy capitalization to take the place of alternative minimum tax and deferred acquisition costs. Proxy capitalization is expressed as a percentage of total premium income for the line of business. For those of you who want to write the proposed numbers down, make three columns. The first column is product line, the second column is Senate package, and the third column is House package.

The House package is basically the package that was submitted October 16, 1990. There were some amendments to the package, but we don't believe the amendments touch this part. In the first column put annuities, group life, noncancellable accident and health, guaranteed renewable health, and all other.

The Senate package for annuities is 1.85% as opposed to 1.5% for the House. For group life, it is 2.2% for the Senate version and 1.8% for the House version. For noncancellable accident and health and guaranteed renewable health, it is 2.2% for the Senate version and 6.75% for the House version. For all other, it is 8.3% in the Senate package and 6.75% in the House package. No one knows where it's going to end up,

and it may end up vetoed. You amortize this on a ten-year straight-line basis. Now there are exceptions and qualifications that I want to share with you for a moment.

Before I do that, let's go through cancelable accident and health. For most of you, this is primarily group A&H business. Twenty percent of your unearned premium reserve is now your proxy deferred acquisition cost, completely equivalent to how property and casualty companies are being treated under Section 847 of the code. You basically have a 20% haircut on your gross unearned premium reserve, and the 20% of unearned premium that was established at December 31, 1990 dribbles in over the next six years -- 3.33% per year being brought into income each year.

Let me go through just a few items here. The House version talks about premiums deemed paid and returned; for example, dividends applied to paid-up additions and premiums waived. They're not includable as premiums. You still do a proportionate alternative minimum tax, deferred acquisition cost expense based on a pro-rata basis through September 29, 1990. There's a small company exemption in the House version. Basically, if you're under $500 million, which is the same treatment for the small life company deduction, you get a 60-month amortization period instead of a 120-month amortization period.

Colonial American under the House version is repealed for ceding commissions deemed to be incurred from September 30, 1990 on. As I said before, this undoes indemnity reinsurance deemed ceding commissions only. It doesn't touch assumption reinsurance deemed ceding commissions.

The Senate version talks about a small company exemption, which is a little bit different and a little bit more beneficial. The Senate version repeals the deferred acquisition expense calculation under alternative minimum tax for all 1990 for small companies (companies under $500 million of assets). For all companies, the amortization period drops to five years on the first $5 million of proxy capitalization, and as expenses increase from $10-15 million, you have a phase-out. For example, at $11 million, you may amortize $4 million over the 60-month period.

I did not see any more pension-plan exemption from these proxy capitalizations. The pension-plan exemption existed in the Senate package a couple of weeks ago. I don't see it in the current package at all.

One thing for the mutual companies in the audience. The House and Senate did not touch the surplus tax. They did not touch Section 809. So to some extent, this arguably inequitable section where you're paying taxes on somebody else's income will continue to exist under the current proposals.

MR. CLONINGER: I have one question I'd like to ask Bob. Based on the information obtained from the survey that your firm performs, do you see a movement toward a common approach to nonstatutory financial measurement by mutual companies? If so, what approach would appear to be the most common?

MR. STEIN: It's a little hard to answer with respect to the traditional participating business. I think on the other lines of business -- interest sensitive other than traditional participating annuities, universal-life-type products -- the vast majority use something that's relatively close to stock life GAAP on the fund accumulation kind of products. The traditional participating business, I would say, is a mixed bag. A number of companies use an FAS-60-type of approach. Perhaps the other significant portions of the companies use a methodology that is really independent of any prescribed accounting model and has driven off some of the pricing methodologies that are in use.

So I think we tend to see a dichotomy of approaches: one where some companies are trying to get more in the mainstream, if you will, in terms of reporting, partly to get the enhanced credibility that using a commonly defined and understood methodology provides; while the other companies are probably doing something that is closer to the fundamentals of pricing and therefore normally would have more ingrained differences from stock life GAAP in it. So there seems to be a split in terms of who's doing what.

MR. LARRY WAYNE GULLEEN: I have a question for Mr. Robbins on the new tax proposal that supposedly went through. Basically, if I understood correctly, now there is a provision to proxy tax both group life and health benefits. Is there also some sort of a proxy tax on Blue Cross/Blue Shield operations included in the bill?

MR. ROBBINS: Blue Cross/Blue Shield has been a property/casualty company for tax purposes ever since the 1986 Act. It already has 20% of unearned premium haircuts. Now I noticed in this that property/casualty companies selling life insurance would be subject to these rules, too.

MR. STEPHEN L. WHITE: I have a question primarily for Mike Tuohy. I'd like to know how you would control the assumptions for the new business profitability in a value-added statement. In particular, do companies know that their new business is returning unacceptably low rates of return on equity so that they could reflect that and would reflect that in their value-added statements?

MR. TUOHY: First of all, as far as validating assumptions that go into the calculation of value of new business, this has to be done with careful analysis of actual experience from year to year. One would look at the movement in embedded value from year to year and see how actual has compared with expected. This analysis of variance would identify where assumptions are overly optimistic. As far as your other question, I'm a bit confused. Are companies pricing to achieve low returns?

MR. WHITE: I think you implied that companies were in fact achieving low returns on new business.

MR. TUOHY: Principally, that was caused by overly optimistic acquisition expense assumptions based on a dubious tenet that goes, "If we price this aggressively, we should double our business and halve our expenses." Many companies carried on doing this for several years without the discipline of reporting massive expense overruns. As Bob showed, the GAAP results, which gradually deteriorate in these circumstances, showed a

drop from 14% ROE at the beginning of the 1980s down to 9% now, reflecting the fact that new business has been written at subpar rates.

MR. WHITE: I guess I would think that there's also a problem -- that companies are assuming that they're going to achieve greater spreads on their universal life products than they are in fact achieving. Under a value-added approach, shouldn't that loss show up very early?

MR. TUOHY: Well, you would see some. Say you just started an interest sensitive product and were aggressive with that assumption early on. The variance analysis would show that the spread was not being achieved. If that was consistent for a couple of years, you'd be forced to reduce that assumption and take a hit. On the subject of spreads, there are various ways of misleading oneself. Clearly companies were kidding themselves about junk-bond spreads by not establishing an adequate default reserve and measuring spread off the high early returns. Similarly, I'm concerned about the heavy investment in collateralized mortgage obligations, where one can pick up the extra 50-100 basis points from the collateralized mortgage obligation. One is picking that up because one has got a much greater variability in duration in those investments, but still a lot of companies are just looking at the yields on those collateralized mortgage obligations and saying, "Aren't I making a great spread!"

MR. THOMAS L. BAKOS: This is for Ed Robbins. It seems to me that you may be frustrating yourself by looking for logic and consistency in the current tax law and regulation. It seems to me that the Treasury has determined that it needs to increase revenue and it has targeted the insurance industry for a specific amount. So isn't the real question how that burden will be spread among the industry?

MR. ROBBINS: Tom, I don't know why you say how it should be spread among the industry, or did you mean industries, plural?

MR. BAKOS: Well, I meant stock and mutual companies, and even within those groups of companies. Certainly the formula as to how the proxy deferred acquisition cost will be calculated and the impact that has on tax will effect two different stock companies differently, as well as two different mutual companies differently. The real concern is, who is going to pay how much as opposed to how much the industry in total will pay.

MR. ROBBINS: I guess it is now, assuming that we've approached the point where Congress is relatively immovable in its desire to tax the industry. The industry has been held up as a sacrificial lamb, pointed at and told, "We're going to get our revenue from you, the industry." Tom, I guess what you're now saying is, it's an argument between what lines of business perhaps get what percentages. This is, I think, where you're coming from. I guess I would agree with that. They seem to be solidifying.

The most major move that happened very recently was the relegation of noncancellable accident and guaranteed renewable health to that lower percentage proxy capitalization under the Senate version. That was a major move for the noncancellable health writers.

MR. ROBERT G. MEILANDER: I've got a question for Mike Tuohy. A moment ago we were talking about changes in spread, and you said that should be reflected in the value-added calculation. My question concerns the discontinuities that happen when you change your assumptions. I guess what I'm curious about is how you handle that, because it seems that if you made a change in the interest rate that you're discounting with at one particular point in time, that would have a massive impact on the value-added for that particular year.

MR. TUOHY: Yes, it can. One has to do the calculations prior to the change and then identify the impact of the change for management information purposes. So you do have to really isolate that. Otherwise, you can get changes in assumptions that will swamp out everything else.

MR. MEILANDER: But you would let it flow through in the one year and just try to identify it.

MR. TUOHY: Yes.

MR. ABRAHAM WEISHAUS: My question is for Mr. Robbins about the current tax proposal. Are there any exceptions for single premium and dump-ins in terms of the premium percentages used for deferred acquisition costs?

MR. ROBBINS: I don't see any.

MR. WEISHAUS: Wouldn't that have a drastic effect on the profits of companies selling those products since, in effect, these are premium taxes that are probably worth about 2% of premium based on present value and the profit margins on those products aren't that high?

MR. ROBBINS: You're absolutely right. Let me go into a couple of the inequities that I see above and beyond that. You've got, for example, the group life case that can lapse next year, and you're amortizing that percentage over the next ten years. This is on total premiums, not just first-year premiums, so you're continuing to capitalize based on deferred expenses you haven't really incurred in most lines of business. I guess I, for one, don't see a huge difference between single premium life sold at net rates where the mortality charge is not being currently charged and a single premium deferred annuity. They're pretty close, really, in nature and the proxy capitalization is quite different on the two things. I guess I would agree with you, yes. It's certainly an inequity compared to the expense that was actually incurred to put that on the books, or could be.