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**SFAS 97**

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- Practical considerations
  - Assumption setting with view to tracking and verification
  - Level of detail and differentiation between products and cells
  - Timing issues – model versus financial reporting
- Unlocking
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  - Universal Life (UL)

MR. EDWARD J. MULLEN: For just over four years, *SFAS 97* has had a very significant and, at times, somewhat troublesome effect on the earnings of publicly held companies – at least those companies with significant blocks of universal life and deferred annuity business. However, I think that companies over this time have begun to cope with some of the issues that have come up. Each of the three speakers will present ideas on a variety of issues relating to this important accounting pronouncement.

The first speaker will be Bruce Darling. Bruce is a senior consulting actuary with Ernst & Young in New York, and he will begin by presenting some ideas on management's perspectives of *SFAS 97*. Following Bruce's talk, Howard Rosen, vice president, responsible for financial reporting at Consec, will talk about his company and some *SFAS 97* issues that affect Consec and similar operations. After Howard's talk, Craig Reynolds, an actuary with Milliman & Robertson in Seattle, will discuss some problems with *SFAS 97* and possible solutions, as well as present some assumption sensitivity analysis for a model universal life product. At the conclusion, Bruce Darling will talk about some practical issues that we hope will provoke further discussion from the group.

MR. BRUCE R. DARLING: I'll be talking about making sense of results under *SFAS 97*. *SFAS 97* is fundamentally focused on the gross profit stream of the types of products that are accounted for under this pronouncement, basically interest-sensitive products like universal life contracts and deferred annuities. Because the gross profit stream is the focus of the pricing in most companies, in setting the objective for returns from these types of products, it seems a shame not to tie together the pricing, reporting, and measurement of results so that these things feed on each other rather than being totally independent. As part of the accounting, what that means is going a few extra steps instead of just concluding with the basic financial information required for your financial statements. I'd recommend you create some additional exhibits for your product lines and years of issues, that tell you what your projections

of gross profit streams actually have been and are projected to be into the future as a by-product of the valuation process. Then, since *SFAS 97* also calls for an unlocking of your amortization schedules that as experience deviates from what was expected, it seems to make sense that you would update these streams for your unlocked experience and ongoing projections of the future.

Now, a change in the amortization rate that comes with unlocking of your deferred acquisition cost (DAC) amortization schedules is always a flag for management attention. If something has happened in the current period for which the valuation is being performed, that event needs to be known by the people who are in charge of the product and the product line or business segment within the product line. Either something has just occurred that management should know about or there is something underlying the product's profitability that is affecting its future profitability as well. Management must ask two questions. First, what differed from our expectations? And second, what can we do about fixing any problems? Can *SFAS 97* help us to get at these questions?

First, let's look at some aspects of *SFAS 97* that differ from what we would probably like to see in our product management reports. Perhaps the most critical shortcoming is that you probably will not get a level return on equity (ROE) pattern by duration even if all best estimate assumptions are met. In fact, not only do you not get a level return on equity, but you also don't really get a level return on your gross profits, which is the basis of your model. The reason is that the accrual of DAC takes place at the credited rate, rather than at the earned rate under the contract. So there's going to be a difference between the level return on margins that you'd expect and what you actually get out of the model.

Another difference is that because you're using best estimate assumptions, quite often you don't use exact pricing assumptions. Pricing, in my view, is often optimistic; if we get what we want, then we will make the profit objectives that we want. Sometimes the accountants won't let you be so optimistic in *SFAS 97* reporting. Also, pricing may include trends that you would not be using in accounting. Finally, pricing may include indirect or overhead expenses that would not necessarily go into your accounting model. So, in summary, you have to make adjustments. You can't use *SFAS 97* results directly without understanding some of these other influences and making adjustments or accommodations for those influences.

Another thing that often confuses users of *SFAS 97* numbers is what unlocking does to the stream of earnings that's recorded under *SFAS 97*. I think it's pretty essential to understand why you get the results that you do under *SFAS 97*. Whenever you substitute actual for expected, or change future estimates of what's going to happen in your gross profit stream, you ought to understand exactly how that affects your earnings. It's helpful to separate the components of unlocking into these different elements.

There was an article published in the *Financial Reporter* newsletter (March 1992). Unfortunately, the *Financial Reporter* left out the definitions of the variables in the formulas, but it does go into detail on how to get to these components of the unlocking picture.

The amortization was higher or lower. It's fairly easy to break it into particular components. The first one is the dynamic amortization effect and that's the deviation in your current period estimated gross profits from expected times the prior schedule amortization rate. So, if you have a difference of say 10% more gross profits, you're going to get that much more amortization in that period than you'd previously expected from this effect. It is called dynamic because it is similar to the approach that is used in traditional amortization: because you have a difference in persistency, and you apply factors times the new in-force business, you get a dynamic effect. This is what we mean by dynamic.

The second piece is what I call the current year unlocking effect. That's where you have the current period gross profits times the difference in amortization rates. The amortization rate is equal to the present value at issue of the deferrable acquisition cost over the present value of gross profits. So, if you are changing the gross profit stream, you are going to change that present value, and you are going to get a different amortization rate. And that change in amortization rate times the current period gross profits is the unlocking effect.

Finally, you have the cumulative catch-up or retrospective adjustment. And that's essentially equal to the accumulated past gross profits times the change in amortization rate. It happens that these three items just sum up, and these three pieces give you your total amortization variation for the period. If you want to go deeper into the mechanics than what I have outlined in the article, there have been a couple of very good *Transactions* articles – one by Joe Tan and one by Mike Eckman – which not only took this approach of defining these components, but took them down to the source of earnings levels as well.

That leads me to the next topic, source of earnings. Source of earnings means taking the deviation from what you expected in your gross profits and allocating it to the various influences that produced it: interest deviations, credited rate deviations, expense deviations, and persistency deviations. There also is mortality if we're talking about a universal life-type product.

What this does is to help you understand what the source of the deviation was for the period. We talked about how mechanically that comes into the final numbers that you produce under *SFAS 97*. As I said, there are some excellent articles. I'm not going to go into detail on how to calculate source of earnings, but will refer you to these sources.

Even though it is valuable to understand these influences, it also is important to understand that many of them are offsetting in any given period, and that you often can achieve your profit objectives even if something is higher since something else may be lower. The important thing is to look at the total gross profit stream of the product. Again, when managing your products I urge you not to stop with the reporting, but to schedule out the gross profit streams that have historically been achieved on blocks of business and to project forward into the future, so that you can see the magnitude of the contributions from each product and how well you're doing against your objectives. With that, I'll let Howard talk about what's been going on in Consecro.

MR. HOWARD L. ROSEN: As Ed said, I'm vice president of Financial Reporting with Conseco in Carmel, Indiana. As many of you know, Conseco is a fairly rapidly growing organization, very much involved in acquisitions and mergers. In fact, in the last three years, we've been involved in four reasonably sized acquisitions that have increased the size of our company. Our primary product line is deferred annuities which are primarily sold through financial institutions. Just to give you a perspective on Conseco and why we are so involved with and concerned about SFAS 97 issues, I thought I'd give you an idea of what the company looks like (Table 1).

TABLE 1  
CCP and CNC Insurance, Incorporated  
Insurance Liabilities March 31, 1993

Future Policy Benefits	Net of Reinsurance Ceded (\$ Million)		
	CCP	CNC	Total
Investments contracts	3,315.6	5,594.8	8,910.4
Limited-payment contracts	152.0	1,361.8	1,513.8
Traditional life insurance	174.3	210.0	384.3
Universal-life-type contracts	477.6	188.3	665.9
Claims payable and other	62.7	71.3	134.0
<b>Total Insurance Liabilities</b>	<b>4,182.2</b>	<b>7,426.2</b>	<b>11,608.4</b>

These numbers do not include Bankers Life & Casualty, which we acquired in November 1992. As you can see, most of our products are in the investment contract area, primarily single-premium deferred annuities (SPDAs); so most of our work in the GAAP area involves SFAS 97 in some manner, way, shape or form.

I would like to briefly discuss some of the issues that are affecting Conseco. Some of the issues clearly relate to lines other than SFAS 97 products. I will try to focus on how the issues are specifically affected by and effect SFAS 97-type products. The two topics that I would like to talk about are the Emerging Issues Task Force (EITF) position on purchase accounting and how the present value of profits (PVP) asset now has to take SFAS 97 into consideration for these types of products. Second, I will discuss the treatment of realized capital gains, both in the unlocking methodology work that everybody does, probably on an annual basis, and also on an interim basis, when you just don't have the time, the facility, or ability to go through and do a full reprojection exercise.

Let me move into the first topic. It has been common practice for companies to acquire other companies. If the acquiring companies are publicly traded, sheet, they would establish an asset known commonly as PVP or PVFP, the Present Value of Future Profits on their opening balance sheet. The asset is frequently calculated by projecting future profits and discounting those future profits at a risk rate of return. Now I say generally because, I know through my experience in a prior life as a consultant, that it is not universally accepted, and it is not the universal practice for companies to project profits and discount them back at a risk rate of return. When I

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say risk rate of return, I'm talking about 15-18%. Some companies take a different approach. However, it is clearly common practice to use a risk rate of return.

It also was common practice for companies who are involved in acquiring blocks of SFAS 97 type of products to ignore the SFAS 97 aspects, such as expected gross profits (EGP), unlocking, etc., when they set up a present value of profits asset. The PVP was not the present value of estimated gross profits. The PVP was the present value of financial statement profits, which includes things other than just elements of EGP. It certainly was the practice for companies to then accrete interest to the PVP asset, as it moves along, using the original discount rate.

Last year, some time around the middle of the year, the SEC looked somewhat more carefully at PVP than it had in the past. There was a new chief accountant at the SEC. He looked at the practice. My understanding and recollection is that the chief accountant, representing the SEC, took exception to the practice that the industry had used to account for PVP and the accretion of interest. The SEC then turned to the AICPA and its Emerging Issues Task Force and told them to take a closer look at this methodology. The EITF then raised certain issues. The issues were first, whether it is appropriate that interest be accreted on the PVP asset not just for SFAS 97 but for any products. Is it an earning asset, or isn't it an earning asset? Second, if it's acceptable to accrete interest on that asset, what should the level of interest be? And third, and this is very critical as far as SFAS 97 products, if you look at the recoverability of that asset, and there's some change in your expectation as to the future profit stream, should you make a change in the pattern of amortization? How should that change be implemented?

Finally, how do you measure recoverability? In my opinion, the recoverability issue has not been thoroughly considered. As you will see in a couple of minutes, if you measure recoverability in certain ways such as the same way that you amortize the asset, unless your block of business is terrible, you will never have a recoverability issue. This is because, if you are establishing an asset at 18%, and measuring recoverability at 8%, you have really got to have a bad block of business or your initial estimate has got to be way off before any problem will appear.

What were the conclusions reached by the EITF and how are they affected or how do they affect SFAS 97 products? First of all, the EITF concluded that it was appropriate to use interest and accrete interest to the PVP asset. Second, the amortization method should be consistent with the method used for the underlying DAC in post-purchase business. Here is where SFAS 97 jumps in for the first time, because by analogy, we are saying that present value of profits asset for SFAS 97 products (e.g., universal life, SPDAs, etc.) should be amortized the same way that the DAC asset is amortized. Again, by analogy, that means you have to use an unlocking procedure.

Note that for SFAS 97 products, we had a gross amortization percentage that normally would be less than one for DAC. When you're talking about the present value of profits, if you're in strict compliance with the accounting literature, APB 16 on purchase accounting, your gross amortization percentage would be one or very close to it. The reason that it would generally be one, is that your present value of profits asset is intended to represent the fair-market value of the book of business

that you've acquired in the transaction. So theoretically, by definition, you should be capitalizing 100% of your gross profits. When you amortize that, your gross amortization percentage should be one.

For *SFAS 97* products, adopting a methodology similar to DAC would require cumulative adjustments. Whenever there has been a material difference between actual and expected experience in the current period, or your expectations about future experience have changed, you should go through an unlocking exercise. Again, just as it is possible to recapture DAC that has been written off previously, by analogy, the EITF position is telling you that you should now be able to recapture a present-value-of-profits asset that has been written off.

There is a grandfather date. The grandfather date is November 19, 1992. For acquisitions occurring after that date, the amortization methodology for *SFAS 97* PVP as well as *SFAS 60* PVP should employ the findings of the EITF. So for *SFAS 97* products, you'll be dealing with restatement and unlocking. For acquisitions completed on or before that date, the current methodology can be continued with, as we understand it, the following exception. Again, this is common practice which is not universally accepted in the industry. There are some companies, Conesco being one of them, which, when they measure the recoverability of the present value of profits asset (and by the way, we do test our prepurchase lines of business, wholly separately from post-purchase) adjust the discount rate as necessary. That is, when we test the recoverability by line of business, by company, for a PVP asset, if we have found (and we have on occasion) that there is an apparent recoverability issue when discounting at the original risk rate of return, we will take the discount rate down to the point where the PVP becomes a recoverable asset. The theory behind that is the present value of profits asset is in the nature of a financial asset acquired in acquisition and if the yield isn't what you thought it was when you bought it, what is it now?

The one exception in the grandfathering process is that for pre-November 19, 1992 transactions, it is no longer acceptable in the eyes of the SEC, the EITF or the AICPA, to take a PVP discount rate down below the level of the then current liability rate. So, again, this is where *SFAS 97* jumps in. If you're looking at the PVP asset for a block of deferred annuities, and you are currently crediting 6.5%, if you must use a 3% discount rate in order to recover that PVP asset, a write-off is indicated. The lowest that you can use, would then be the current liability rate.

Table 2 illustrates how the EITF methodology works. I should add that we, at Conesco, do not have any postgrandfather date transactions. Everything that we have done up to this point has been a pregrandfather date transaction. So we are, for the most part, maintaining what I've always considered the traditional PVP methodology. And virtually all of our PVP assets are at their original acquisition discount rate.

Traditional methodology says, for some hypothetical block of business, you project your gross profit stream, the GAAP financial statement gross profit stream, and you come up with a PVP asset at time zero by discounting that stream at some risk rate of return such as 18%. Hence, at acquisition you get the present value of this block of business of \$83.5 million. Using traditional methodology, we would then accrete

TABLE 2  
 Example of the Impact of the EITF Method  
 on PVP Amortization  
 Declining Income

Year	(1) Gross Profit	(2) Traditional PVP @18%	(3) PVP @8%	(4) Adjusted Gross Profit	(5) EITF PVP	(6) Inc Recognition Trad Method	(7) Inc Recognition EITF Method	(8) Income Impact	(9) % Impact on Inc of EITF Method	(10) Cumulative Impact
1	\$21,400,000	\$83,519,004	\$134,706,266	\$13,268,179	\$83,519,004	\$15,033,421	\$14,813,342	(\$220,079)	-1.46%	(\$220,079)
2	20,300,000	77,162,425	124,082,767	12,686,170	76,932,346	13,887,436	13,868,418	(19,018)	-0.14	(239,098)
3	18,600,000	70,739,861	113,709,377	11,532,165	70,500,764	12,733,175	12,707,906	(25,269)	-0.20	(264,367)
4	17,100,000	64,873,036	104,206,128	10,602,143	64,608,670	11,677,147	11,666,551	(10,596)	-0.09	(274,963)
5	15,700,000	59,450,183	95,442,618	9,734,131	59,175,220	10,701,033	10,699,886	(1,146)	-0.01	(276,109)
6	14,200,000	54,451,216	87,378,027	8,804,119	54,175,107	9,801,219	9,728,890	(72,329)	-0.73	(347,438)
7	12,900,000	50,052,435	80,168,269	7,998,108	49,704,997	9,009,438	8,976,292	(33,146)	-1.46	(478,585)
8	11,900,000	46,181,873	73,681,731	7,378,089	45,663,289	8,309,137	8,176,564	(132,573)	-1.60	(611,158)
9	11,000,000	42,571,010	67,876,269	6,820,092	41,959,852	7,662,782	7,536,896	(126,086)	-1.65	(737,244)
10	10,100,000	39,233,792	62,090,371	6,262,084	38,496,549	7,062,083	6,917,640	(144,443)	-2.05	(881,687)
11	9,400,000	36,195,875	56,957,601	5,828,079	35,314,188	6,515,257	6,297,057	(218,201)	-1.81	(999,888)
12	8,600,000	33,311,132	52,114,209	5,332,072	32,311,245	5,996,004	5,852,828	(143,176)	-2.39	(1,143,084)
13	8,000,000	30,707,136	47,683,345	4,960,067	29,564,072	5,527,284	5,405,059	(122,226)	-2.21	(1,265,289)
14	7,400,000	28,234,421	43,498,013	4,588,062	26,969,131	5,082,196	4,968,469	(112,727)	-2.22	(1,378,017)
15	6,900,000	25,916,616	39,577,854	4,278,058	24,538,600	4,664,991	4,585,030	(79,961)	-1.71	(1,457,977)
16	6,300,000	23,681,607	35,844,082	3,908,053	22,223,631	4,262,689	4,171,838	(90,851)	-2.13	(1,548,828)
17	5,800,000	21,644,297	32,411,609	3,596,048	20,095,468	3,895,973	3,811,589	(84,384)	-2.17	(1,633,213)
18	5,400,000	19,740,270	29,204,638	3,348,045	18,107,055	3,553,249	3,500,519	(52,729)	-1.48	(1,685,942)
19	4,900,000	17,893,519	26,140,901	3,038,041	16,207,577	3,220,833	3,158,565	(62,268)	-1.93	(1,748,210)
20	4,500,000	16,214,352	23,332,173	2,790,038	14,466,142	2,918,583	2,867,254	(51,330)	-1.76	(1,799,539)
21	4,200,000	14,632,935	20,898,747	2,604,036	12,833,396	2,633,928	2,622,637	(11,292)	-0.43	(1,810,831)
22	3,800,000	13,066,863	18,154,646	2,356,032	11,266,032	2,352,035	2,344,451	(7,585)	-0.32	(1,818,416)
23	3,500,000	11,818,899	15,807,018	2,170,029	9,800,483	2,091,402	2,114,009	22,608	1.08	(1,795,808)
24	3,200,000	10,210,301	13,571,579	1,984,027	8,414,493	1,837,854	1,889,133	51,279	2.79	(1,744,530)
25	3,000,000	8,848,155	11,457,306	1,860,025	7,103,625	1,592,668	1,708,265	115,597	7.26	(1,628,932)
26	2,700,000	7,440,823	9,373,890	1,674,023	5,811,890	1,339,348	1,490,929	151,581	11.32	(1,477,352)
27	2,500,000	6,080,171	7,423,802	1,550,021	4,602,819	1,094,431	1,318,205	223,774	20.45	(1,253,578)
28	2,300,000	4,674,602	5,517,706	1,426,019	3,421,024	841,428	1,147,663	306,234	36.39	(947,344)
29	2,100,000	3,216,030	3,659,122	1,302,018	2,268,686	578,885	979,477	400,692	69.20	(546,752)
30	2,000,000	1,694,915	1,851,852	1,240,017	1,148,164	305,085	851,836	546,752	179.21	0

18% interest to the asset. Since our assumptions were exactly correct, we would be amortizing \$21.4 million in the first year on a gross basis. In the second year, it's \$20.3 million, and we would be earning 18% on that asset. We certainly would have no deviations from experience. So our block of prepurchase business would yield 18%. This is the methodology with which the SEC took exception. How can a company earn 18% on a block of business when companies that are marketing the business can't make more than 5% or 6%?

The answer is, hey guys, you set the rules. We're following them. We're not using smoke and mirrors. This is the accounting model that you set up. Our accounting brethren took exception and said, "No, you can only accrete a liability rate." Now for illustration purposes, let's pretend that the liability rate at the date of acquisition was 8%. The way that we envision the EITF methodology working is that you would take that same stream of gross profits and discount it at 8% and then at the acquisition date take the ratio of the only two important numbers in this illustration, in this part of the talk, the \$83.5 million and the \$134.7 million. You would take the ratio of those numbers, and multiply it times your gross profit stream and get what I've labeled as the adjusted gross profit stream. This column contains the gross amortization amounts that replace the original gross profits in the amortization process. The EITF did not say that you had to change the way that you calculate your opening balance sheet asset. You may still calculate that asset by discounting the stream at a risk rate of return. But, you would amortize the PVP by accreting 8% (in this case) and subtracting the amounts in the adjusted gross profit stream column.

The EITF has said intuitively and implicitly that, even if your assumptions are exactly correct, even if every cash-flow assumption that you've set is met exactly, and you purchase that asset to yield 18%, we believe 18% is improper. In this case they believe 8% is the most that you should accrete in terms of interest. So what happens? You are amortizing the same asset over the same period of time, but you're accreting lower interest and for the most part, you get lower profits. For the most part, the real mechanics and whether or not you get lower profits will depend upon the nature of the blocks of business acquired. We have one company for which the gross profit stream, if we adopted the EITF methodology in the early years, would actually be higher.

The EITF PVP is column 5. It is calculated by taking your 18% PVP, accreting 8% to it, and then subtracting out the adjusted gross profits. As you can see, in this particular instance, because you are accreting lower interest, you, in fact, have lower earnings. The income impact is in column A. In the early years, you are earning lower GAAP profits, after amortization of PVP. In the first year, there is a \$220,000 negative impact. In the second year, it is \$19,000. But if you're starting out with the same asset, and you're amortizing that asset over the same period of time, by definition you have to wind up with the same total amount of profits, so you make it up in later years. In fact, after year 22, you can see that the profits turn around. This type of result for our company is not one that we relish.

MR. CHARLES D. FRIEDSTAT: That was a good example. If you follow the commonly accepted approach as you have called it, you have an 18% return on investment in all years. What would your return on investment be under the EITF



approach? Obviously, it is going to be lower in the early years and higher in the later years.

MR. ROSEN: I don't know. That's a good question. It will clearly be lower in the early years, but it is not one that companies that are into acquisitions and turning those acquisitions to the public, as we have done more recently with CCP and Banker's Life & Casualty, relish. There is one point that I don't understand and I guess I will never understand, even though I spent a number of years in an accounting environment: if you're making an acquisition and that acquisition is priced to purchase 18%, and you've been right about everything you said, why can't you earn 18%? I'm sure there is a common theory there.

At any rate, this is the way the EITF methodology works. When you have a SFAS 97 product, you're going to have to go back and reestimate the Gross Profit column, then go back to issue and reestimate the Adjusted Gross Profit column. A question I have, and I don't know how it's going to shake out, is what happens when you go back and reestimate the Gross Profit column and you don't get \$83 million?

It seems to me that you're going to have to start with and stay with \$83 million forever. But you're going to have to unlock and you're going to have to restate and you'll have cumulative adjustments. You can recapture PVP on SFAS 97 lines.

Let me move ahead. The last issue that I'd like to talk about is realized gains and the treatment of realized gains in unlocking exercises. We'll spend a couple of minutes on the traditional procedure and then get into a methodology that we have adopted at Consecro for interim periods because Consecro is a company that does very careful and extensive asset portfolio management.

Again, for a company like Consecro which actively manages its asset portfolio, realized gains and the treatment of realized gains are very critical. We all know that when you take realized gains, they must be considered in SFAS 97 DAC amortization and, as I just mentioned, EITF amortization of PVP accounting. There is a general procedure that has appeared in actuarial and/or accounting literature.

First, distribute the realized gains to the lines of business from which they came. Now, for a company like Consecro, allocating the realized gains to companies is not a problem. They have their statutory portfolios. We know which assets we sold and on which assets we took capital gains. So we can allocate the realized gains directly.

The problem comes when we have to allocate gains by line of business, particularly by SFAS 97 lines of business. This is because not only do we actively manage our portfolios and assets are moving around a lot, but we do not have a formal asset segmentation program. The assets are managed by the investment department. There is reasonably good communication but lines of business do not own assets. And to a certain extent, because we have single premium immediate annuities (SPIAs) and deferred annuities, things are internally hedged, but there is no direct asset segmentation.

Once you have distributed your gains, you then would add the gains to your estimated gross profit streams for DAC and for new acquisitions to your GAAP financial

statement profit streams for PVP. You would then adjust the future yields because theoretically, if you've taken the capital gain, you have foregone future investment income. You would then adjust other assumptions in your projection, mortality, lapse, anything that has materially changed, and do a reprojection. Then go back and determine the cumulative DAC and/or PVP adjustment that is necessary. Again, you're considering capital gains and you do this at times during the year when you've either planned or have time to do a full-blown reprojection.

But what about periods during the year? You don't take capital gains at one time. What about at interim dates? Frequent reprojections are just impractical. You don't have time because if all you're going to be doing is reprojecting, you won't have any time to help your company make money. So it's necessary to take a practical and expedient approach. At Conseco we have taken a conservative approach by first assuming that realized gains are not accompanied by changes in credited rates. How do we rationalize that? Realized gains are taken at the discretion of management, as opposed to changes in secular interest rates, which would cause us to change crediting rates. We make this assumption to facilitate the methodology that I've put together.

First, we assume that realized gains are not accompanied by changes in credited rates. Furthermore, realized gains change only the incidence of profits, not the total amount. Why? Because a realized gain in theory, in the perfect world, represents the present value of foregone interest. So it would represent the present value of a stream of income, discounted at a rate equal to the yield on the sold assets, for a period of time equal to the years to maturity of the sold assets.

Now, we would calculate that level amount. We have our gains. We have essentially, by company, the assets that have been sold. I get a listing on a quarterly basis. But because of timing and because this procedure really happens just before the end of our reporting period, I'm usually one quarter behind in my asset reports. But we get a report as to which assets have been sold. The realized gains, then, represent some level amount of foregone interest. That level amount is  $x$ , and  $x$  is the payment whose present value over a period of years, discounted at the yield to maturity of the assets, equals the realized gains.

I'm going to allocate that stream to lines of business, pre- and post-purchase. Unless I've got a serious recoverability problem, it's only a germane issue with respect to SFAS 97 products, because it's only with respect to SFAS 97 products that I'm supposed to directly take realized gains into account unless, of course, a recoverability problem has occurred.

I've allocated my income stream; now what I'm going to look at my lines of business with DAC and PVP. I take my allocated stream and discount it at whatever the appropriate DAC or PVP discount rate is. If I've allocated a stream of payments of  $x$  per year to a DAC line of business, if you will, with a DAC discount rate of 6.5%, I'm going to take that level payment for, say, 20 years and I'm going to discount it at 6.5%. This becomes the basis for my SFAS 97 amortization. I will then apply my gross amortization percentage to that number and the result is my incremental amortization. That is the impact of realized gains on that line of business.

MR. ROBERT LALONDE: Howard, have you had a chance to think about what effect the proposed mark-to-market change in asset values will have on the strategy you're talking about?

MR. ROSEN: Oh yes, in fact we do mark-to-market adjustment – I think we're one of the few companies that have actually been doing a mark-to-market adjustment since September 1992. I go through this same type of exercise of allocating realized gains, in this case, unrealized gains and losses to lines of business. The question is not what is the impact on DAC or PVP but what would the impact on DAC and PVP be if we took the unrealized gains and losses we have in our portfolio? We do make unrealized adjustments to our balance sheet every quarter, to account for that. The difference is that the adjustments resulting from this methodology for realized gains and losses run through our income statement and, for all intents and purposes, are permanent. The adjustments we make for the mark-to-market adjustments run through surplus and disappear one second after earnings are released. The reason they disappear is that it's a snapshot of unrealized gains and losses at that financial statement date.

MR. LALONDE: If that mark-to-market ruling is implemented, it'll be followed just like the treatment of realized gains.

MR. ROSEN: We believe that it will be an unrealized adjustment.

MR. FRIEDSTAT: On any amounts that go through income, you should adjust the revenue stream and the amortization under SFAS 97. I don't think the unrealized amounts will come through net income. The amounts that you're talking about that will go through mark to market and through the surplus adjustment, should not be used to adjust the revenue stream.

MR. ROSEN: I would add that we look only at our mark-to-market unrealized DAC and PVP adjustment on realized gains that are not taken in the trading account. We do not consider trading activities at all. And if you're familiar with what has been going on with the mark-to-market concept (the SEC has decided to force it on insurance companies and banks), you know it hasn't changed actuarial practice. It's a reinterpretation of what has always been.

There are three classes of assets. One class of assets is made up of those assets that are purchased with the sole intent to be traded. The second class of assets is made up of those assets that are bought with the intent and ability to hold to maturity. That is, no matter what, you're going to hold those assets to maturity. The third classification is made up of those assets where if things changed such that it was advantageous from a business standpoint for you to sell the asset, you would.

MR. FRIEDSTAT: I think the interesting question ties in with Bob's comment. Assume you have securities that are in the trading category, where the gains and losses would go through the income statement as realized gains. With those realized gains, which are realized in the income statement but not realized in the sense of having sold those assets, would those or should those gains or losses be added to your estimate of gross profits for SFAS 97? It probably should for trading category assets that are allocated to the SFAS 97 lines of business. That's where I don't think

that many companies have thought about the effect of this rule on their operations and income. Do you have any thoughts about that particular question?

MR. ROSEN: We would rationalize that assets in our trading account back capital and surplus. Therefore, we would not have to consider that.

MR. FRIEDSTAT: Okay. That may be an appropriate allocation if you have the flexibility to do that, but wouldn't you agree that if there are assets in the trading account backing a line of business, that you would have to reflect these realized gains on assets you haven't sold in your estimated gross profits?

MR. ROSEN: Theoretically you would, but I would question whether or not the yield on those assets, which are always on a mark-to-market basis, was taken directly into account in your *SFAS 97* assumptions, and your gross profits. That is, if those assets had a market yield and you sold them to realize the market yield, hypothetically you've already considered it.

MR. FRIEDSTAT: I think though that we're starting to be concerned about whether companies are saying, "If we, for whatever reason, allocate assets in the trading account as backing a line of business, this could cause wide swings in our earnings for the year, just because of the change in the carrying value of those assets."

MR. ROSEN: Agreed. Now we've allocated our realized gains by line of business. We've taken present values for our DAC asset. We have applied the gross amortization percentage to the amount of money and we've said, okay, this represents the incremental amortization that we should take because of the realized gains. We will then write off our DAC.

We do the same thing for PVP, except with PVP we are discounting that stream at some rate, like 18%. With PVP however, at least on a theoretical basis, your gross amortization percentage is 100%, because the PVP asset, conceptually, is 100% of the fair market value of the block of business that you've acquired. You would then look at the margin for recoverability that you have in your present-value-of-profits asset. Theoretically, you would not be required to take a write-down in the PVP until you've eaten through your margin. Again, we have generally taken the conservative tact at Consec, that we have no margin and so to the extent that I've allocated gains and I've discounted them at 18%, I'm going to take that write-off.

So, let me close by saying this is the methodology that we've adopted at interim periods. It's not intended to be theoretically pure. While I'm trying to get it as theoretically pure as I can, it's a practical expedient. It is generally done at the eleventh hour during our reporting process, because it is not until the end of that process that we know what our gains are. But we do use it. Now every year when you go through your formal unlocking process, you cleanse your soul. You clean up all the approximate activity because you will go back and you will cumulatively adjust for actual experience. Then, the next quarter, you start the process again.

The final point that I mentioned a little bit earlier with respect to realized gains, is that these adjustments go through the income statement. With respect to unrealized gains and the mark-to-market adjustment for debt securities, the adjustments run

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through surplus and as soon as the financials are released, the adjustment is gone. Why? Because it's based on a snapshot of unrealized activity. If I've taken an unrealized adjustment to DAC or PVP based on \$100 million of realized gains, interest rates shift and go up, and I no longer have any realized gains or unrealized gains in my portfolio; I have no basis for any adjustment.

MR. CRAIG W. REYNOLDS: I am from Milliman & Robertson in Seattle. I am going to talk about some less esoterical and more practical or basic aspects of *SFAS 97*.

First, I'd like to talk about something that we all know about: the problems with *SFAS 97*. First and foremost is the lack of information. That is something with which everybody struggles. Second, there are clumsy systems, difficulties maintaining the amortization schedules, and problems building the models. Third, assuming that you can go through the steps of creating an *SFAS 97* model, we found that most of our clients are not really doing any sort of meaningful analysis to understand their results. I am going to talk about that a little bit and tie it into some of the things that Bruce mentioned.

Perhaps what's most important is once you jump through all the hoops, and have prepared *SFAS 97*-based financial statements for your company, we would like to think that there is a potential to get more use out of the information than just preparing a financial statement. There is a lot of work in information gathering. You don't want it to go to waste.

I will talk about each of these issues a little more. Lack of information can take several forms. First, it may not be timely. To the extent that companies are doing lapse studies, mortality studies, etc., that sort of information is often not available until long after financial statements need to be prepared. There may be an inadequate level of detail in the sort of information that you do get. Companies often try to maintain *SFAS 97* DAC amortization schedules on a product level, or even an age level basis in their model. The information is often not available at that level of detail. Finally, at some companies, some information is not available and you are stuck.

I also am going to get into the area of systems. We have seen some pretty scary things. One of the most common problems that companies have is that there are just too many cells in their model. Sometimes, for reasons of practicality, or for reasons of model fit, it is desirable to have a large number of cells representing every plan and issue year of any significance that you have. Perhaps you might even have several ages or sexes within each plan. But for purposes of maintaining an amortization schedule, using that many cells is usually very impractical.

Second, we've seen some scary things with companies that are trying to keep their models updated to adjust for actual experience, where they make numerous interim sorts of adjustments to their assumptions, trying to force their models to fit actual experience. We have come up with more approximate, but certainly acceptable, alternative methods. We make adjustments in aggregate, rather than tweaking assumptions. I will talk more about this later.

When we start talking about the analysis of deviation, there are essentially three key questions that should be asked. First, what caused the deviation? Is it a question of

just having bad information to begin with when you built your models? Has there been a legitimate change in our experience? If it is actually a change in your experience, you need to know. Is it a one-time occurrence or is it something that is recurring? Now that's often something that requires judgement to decide. Suppose lapse rates go up in one year. You do not often have a basis for deciding whether that is going to continue. But as we will see when we get into the examples I am going to show you in a few minutes, that is a decision that has a very material impact on your financials in the current period.

The third question you can be asking is, given that we have changed our assumptions and that we know what the change has done to the current period's earnings, what will be the impact in the longer term on the earnings of the block of business or for the company as a whole?

Finally, before I get into the examples that show how we can solve some of these problems, I will discuss the inadequate use of information. Suppose that you have gone to the trouble of building a *SFAS 97* model (often a similar model or a subset of what you've used for cash flow testing or other purposes). You have a wonderful opportunity to tie that back to your pricing and your repricing process. By *SFAS 97's* very nature, if you are maintaining a schedule of both history and of future, you have a real opportunity, that many companies are missing, to manage your business. You can now look at your financials and ask, when we priced this business we were expecting a 14% or 15% return on equity (ROE). We know what we are earning in terms of ROE this year; do we have any reasonable basis to know whether our profit goal is still reasonable or not? If not, what can we do about adjusting spreads, adjusting loads, etc., to try and correct those problems?

Now lets look at some solutions or partial solutions to these problems.

First, when we work with situations like this, a key criteria that we look for to achieve success is small models. As I mentioned earlier, we may have a large model in terms of a large number of cells to develop a projection. In fact, we will usually develop a projection using a large number of cells. But it is not desirable, or even necessary, to maintain the DAC schedules on a cell-by-cell basis. Typically, we will aggregate the results for all of our model cells for a given major product or product category for each issue year. We then have a much smaller number of amortization schedules to maintain.

Each year we would like to base a projection of the future on a new in-force file and current assumptions about what we believe is going to happen in the future. We are going to reproject the block of business going forward in terms of what we expect for the gross margins in the future. When we do that, since that is being done every year, we are going to have available to us, what we projected last year for that block of business and what we projected the year before for that block of business, and so on.

Conceptually, we start with issuing a block of business. We do an initial projection, which is used only for one year. At the end of that year, we do a reprojection and we take what we projected last year for activity prior to this year, and combine it together with this year's projection of the future.

That overlay process is often cumbersome. Allocation issues are one of the key reasons that it might be cumbersome. Consider an example of something like commission payments. You may have some assumptions in your model about rates of commission payments. You know that your deferred annuities are paying 6% for example and you are deferring that. But many companies often do not take into account commission bonus programs and overrides in developing their initial model. Oftentimes, these are not anticipated. If it is nearly the end of the reporting period, allocating that sort of experience down to model plans or cells is often difficult.

Typically, we use our projection model and some tools we built that allow us to overwrite selected model results with actual experience. Actual experience may be an aggregate number, perhaps total commission payments, or perhaps it may be broken down by issue year or plan. But whatever level of detail we have, we then allocate our experience down to the major product-issue year cells in proportion to what our model had projected. So the model is used as a basis for allocation, but then we scale the model numbers up or down to hit the actual for that year.

That is a key for how we proceed. I have worked through some numbers here that I am going to talk about for a hypothetical insurance company that just started issuing universal life business three years ago. We are going to look at what happens with this company. It is issuing a backloaded UL, with a fairly typical level of profitability. When a couple of different things happen to their experience, then you will see what is important and what you can focus on when you are gathering information.

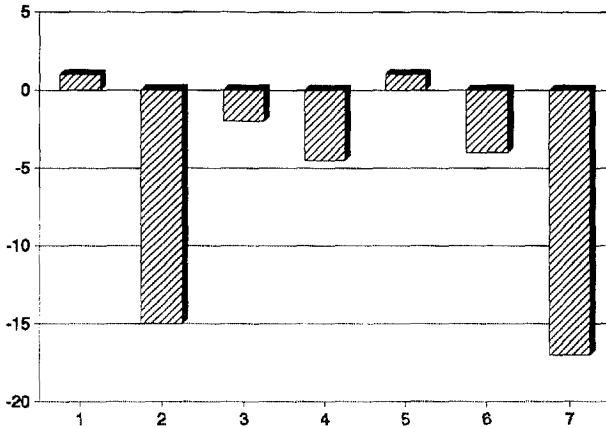
The first case we are going to look at is where everything happens exactly as expected. For the second case, interest spreads of the product are reduced from a 2% anticipated at issue down to 1%. We also test a 20% increase in lapse, mortality up 20%, and an example with some capital gains. We are going to look at the three middle examples (with the reduced spreads and mortality and lapses up) two different ways. First, what happens if you assume that these deviations are one-time shocks that have occurred in one year. Second, what is the effect if instead of assuming that it is a one-time shock, you assume that it goes on forever. What is the impact?

Now, the first and most obvious way that the information is used is to look at the DAC. That's a big part of what SFAS 97 is all about. The numbers in Chart 1 are in thousands of dollars, relative to a base DAC of about \$250,000. The first column shows the effect on DAC if we just adjust the interest spread down 1% for 1992 only. On the other hand, if we assume that it goes down for 1992 and later, the DAC effect is in the opposite direction and of a much greater magnitude. With the lapses, a 1992 lapse adjustment causes the DAC to go down. Because this is a young block of business and the surrender charge revenue is greater than the lost revenue or lost margins from interest margins, amortization increases in the current year, and if we assume that the lapse adjustment goes on forever, DAC goes down a little bit further, but not as dramatically as the difference was on the interest spread change. You see similar things for the mortality and for the capital gains.

Any one of these things could happen to your company. Is there any way you can look at those results and make any sense out of them? Anybody can certainly crank through the numbers and prepare a statement, but then you have to go to your

managers and your officers, and explain why earnings behaved the way they did. What is happening?

CHART 1  
Changes in DAC Due to Experience Deviations  
Total Effect



- |   |                         |   |                            |
|---|-------------------------|---|----------------------------|
| 1 | 1992 Spread Adjustment  | 5 | 1992 Mortality Adjustment  |
| 2 | 1992+ Spread Adjustment | 6 | 1992+ Mortality Adjustment |
| 3 | 1992 Lapse Adjustment   | 7 | Capital Gain Adjustment    |
| 4 | 1992+ Lapse Adjustment  |   |                            |

There are few key things you can do. First, you can look back at the amortization rate, the currently anticipated present value of deferred costs to the present value of expected margins. In the left column of Chart 2, we see an amortization rate of about 0.42. That was expected. If the interest spread goes down for just one year, the amortization rate increases ever so slightly. It is a one-time shot. It does not matter all that much. On the other hand, if the spread reduction continues forever, there's a huge increase in the amortization rate. It jumps up to about 0.55.

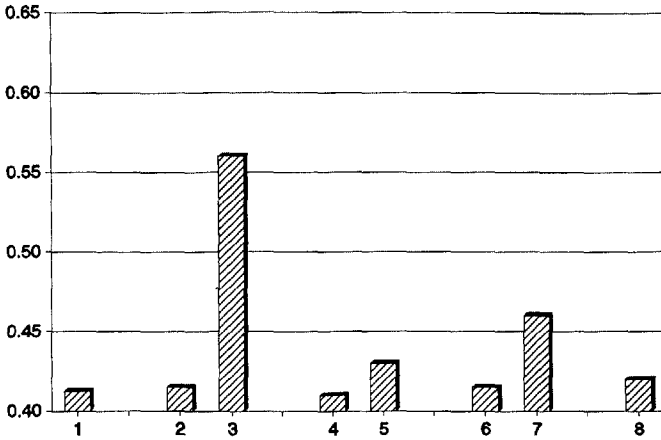
Similarly, for the lapse-rate phenomena, there were just very slight changes in the amortization rate. The mortality adjustment can get moderately significant if it goes on forever. The capital gain does not have a great effect. You have a large realized gain in investment income in the current year, but it is offset by lower yields in the later years.

Now that is a start towards getting some understanding. But if you want to get some greater depth of understanding of what is going on, some of the things that Bruce has talked about can be helpful.

Using the terms that Bruce used – dynamic amortization effect, cumulative catch-up effect, and the current-year unlocking effect – you can look at what happens for each of these changes. With the 1992 spread adjustment, the DAC has gone up because the current year's spread income was lower than was anticipated (Chart 3).

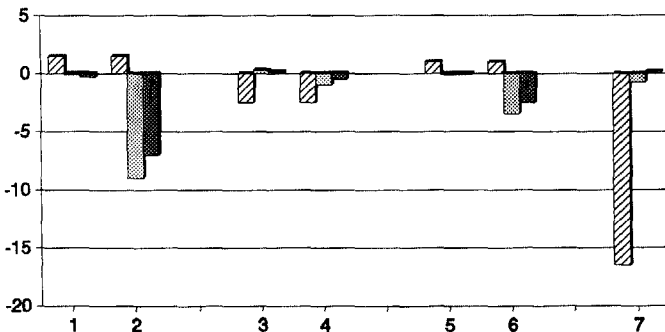


CHART 2  
Amortization Rate



- |                                  |                              |
|----------------------------------|------------------------------|
| 1 Experience Matches Assumptions | 5 1992+ Lapse Adjustment     |
| 2 1992 Spread Adjustment         | 6 1992 Mortality Adjustment  |
| 3 1992+ Spread Adjustment        | 7 1992+ Mortality Adjustment |
| 4 1992 Lapse Adjustment          | 8 Capital Gain Adjustment    |

CHART 3  
Changes in DAC Due to Experience Deviations



- |                             |                            |                               |
|-----------------------------|----------------------------|-------------------------------|
| Dynamic Amortization Effect | Cumulative Catch-up Effect | Current Year Unlocking Effect |
|-----------------------------|----------------------------|-------------------------------|

- |                           |                              |
|---------------------------|------------------------------|
| 1 1992 Spread Adjustment  | 5 1992 Mortality Adjustment  |
| 2 1992+ Spread Adjustment | 6 1992+ Mortality Adjustment |
| 3 1992 Lapse Adjustment   | 7 Capital Gain Adjustment    |
| 4 1992+ Lapse Adjustment  |                              |

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Therefore, less amortization takes place in that year. That is the dynamic amortization effect. There are smaller effects related to the current year unlocking and cumulative catch-up.

If you look at the next column, if the spread goes down in 1992 and beyond, the dynamic amortization effect is the same because that is a change due entirely to what has changed in the current year. But the cumulative catch-up effect and the current year unlocking effect go in opposite directions and completely drown that effect out. You can do a similar sort of analysis all the way through, until the capital gain adjustment in the far column is very dramatic. The effect is very dramatic because I used a very contrived example, where half the portfolio had very significant gains in it and was turned over.

Looking at an analysis like this is very helpful and I thank Bruce for pointing it out to me. To see where you are going and what is causing it gives you some feel for what is going to happen in the future.

Now once you have all that information, what do you do with it? One of the things you can look at is the effect on the bottom line. Once you have a model built and maintained, you can start thinking about pricing and you can look at two different things.

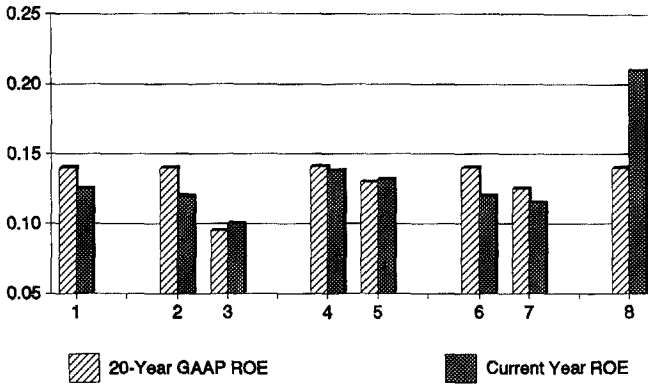
In Chart 4, the darker bars reflect the ROE in the current year for the block of business for which you are using GAAP. The lighter bars represent the cumulative ROE over 20 years for the block of business. If you do an analysis like this, you can start to get a feel for what is important and what is not. You will see what drives things in the short term versus what drives things in the long term. For example, in the far right column, the ROE has gone way up in the current year due to the capital gains effect. On the other hand, the overall lifetime of the business ROE is insignificantly changed. In fact, very few one-time, one-shot things are going to have a material impact on the lifetime ROE of the business. Some of them are going to have a fairly material impact or decrease in the current year's ROE, but very little will have a product life cycle effect.

On the other hand, you can see what happens if you project a continuation of current experience. For example, say it is 1992 and you get a 1% spread in that year alone, and you decide to see what happens if this reduced spread is effective forever. You can see that the cumulative ROE of the product has dropped from a relatively healthy 13.5-14%, down to something below 10%, which most companies would probably find unacceptable.

I think these are the sort of figures you need to be looking at as you adjust your assumptions and look at them. If you start to see on a block of business that you're getting ROEs like this over the lifetime, it starts to bring home the fact that, being willing to give up this sort of spread is probably unacceptable from a GAAP earnings point of view. I think this is a healthy sort of thing that we try to look at whenever we can.

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CHART 4  
GAAP ROE



- |   |                                |   |                            |
|---|--------------------------------|---|----------------------------|
| 1 | Experience Matches Assumptions | 5 | 1992+ Lapse Adjustment     |
| 2 | 1992 Spread Adjustment         | 6 | 1992 Mortality Adjustment  |
| 3 | 1992+ Spread Adjustment        | 7 | 1992+ Mortality Adjustment |
| 4 | 1992 Lapse Adjustment          | 8 | Capital Gain Adjustment    |

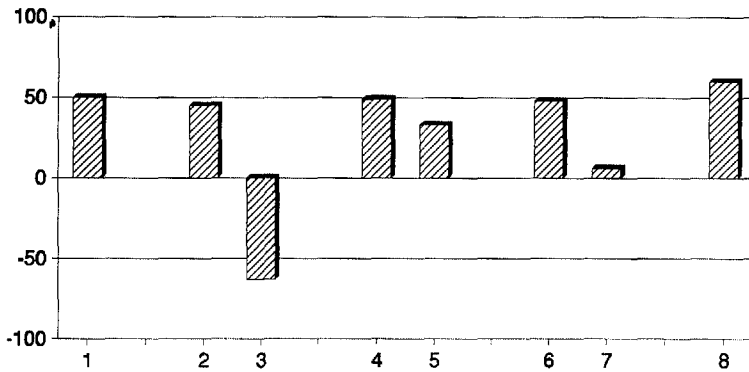
Some of the clients that we deal with are not as GAAP-earnings-driven as many companies out there. They go through SFAS 97 for the exercise more than anything else. Sometimes these companies are smaller companies of larger parent organizations. Sometimes the parent is overseas and the U.S. GAAP is less relevant. You can still get value out of this exercise. Most companies would not otherwise maintain a record of historical earnings on a block of business because it is not really relevant. You are generally looking forward. However, once you've gone through the effort of building an SFAS 97 model, even if you are not GAAP oriented, you can then use that model and that information to do a similar sort of analysis on the basis of statutory earnings.

In Chart 5 we show the present value of statutory profits for the block of UL aggregated together and the effect these experience deviations will have on the statutory earnings. So again, this is the sort of opportunity you have to gather this information and start screening out what is material, what is not, what you need to worry about, and what you do not.

To recap, the key things you should be looking at now, to decide if you have a good SFAS 97 procedure are:

- Manageable model size;
- A system for using the actual data where it is known;
- Where it is unknown, use either model projected data straight out, or use the actual to the extent that it is known and use your model to allocate actual;
- Profitability analysis on the business, so that you get some understanding of how and why the DAC is being affected by the experience deviations.

CHART 5  
Present Value of Statutory Profit



- |                                  |                              |
|----------------------------------|------------------------------|
| 1 Experience Matches Assumptions | 5 1992+ Lapse Adjustment     |
| 2 1992 Spread Adjustment         | 6 1992 Mortality Adjustment  |
| 3 1992+ Spread Adjustment        | 7 1992+ Mortality Adjustment |
| 4 1992 Lapse Adjustment          | 8 Capital Gain Adjustment    |

MR. LALONDE: I was looking at your GAAP ROE charts and thinking what if you did the calculation you made for the whole universal life or annuity line of business -- you have GAAP ROEs and GAAP surplus allocated specifically to that particular component. Which means there are all kinds of complicated questions to which you must answer, what do you do about taxes and allocation of assets and how did you get GAAP equity in the first place?

MR. REYNOLDS: In this case, it was really easy, because I did not have to worry about those things; they are contrived examples. In a real world, I think you are right. There are some complicated issues there, and I think, typically, we would do the analysis based on some concept of target surplus associated with the line of business. We would decide what the company's target surplus levels are and allocate them down to each line. You are right; it is not very useful to look at it in the aggregate for purposes of deciding on corrective action and what is material and what is not. You are going to want to be down to at least a product level, perhaps even the issue-year level. One of the advantages of maintaining a product issue-year cell basis is that you can track two different things. One, you can look at the level of probability of different products relative to each other. If you have issue-year-specific models, you also can track and look for cross-generational subsidy, with which a lot of companies have trouble. The one on taxes is one I have not thought about a lot, but I am sure there are some issues there too.

MR. DARLING: We have had some very interesting discussions. I want to discuss various practical issues related to *SFAS 97*.

First, I want to explain the handout, "*FAS 97 Revisited*." It is a survey of *SFAS 97* practices that was conducted by Ernst & Young in 1991. At that time we took a

look at the practices of 25 of the 30 largest insurance companies. It addressed about 100 different issues related to the implementation of *SFAS 97*. This survey was taken just before AICPA Practice Bulletin 8 came out. So the practices that are described were used prior to that practice bulletin. For example, at the time, there was no guidance that SPDA should be accounted for using the universal life-type accounting model. Also, it wasn't yet clear that capital gains should be included in estimated gross profits. So, I think that on a couple of those counts, the practices that are described in this booklet have probably changed a little to conform with what the practice bulletin is requiring.

The various companies reporting on *SFAS 97* have evolved in their practices as they've learned what works and what doesn't work. As Craig was pointing out, I think that there's a growing feeling that factor-based methods do not work very well for a number of reasons. They don't provide much management information because the factors at a cell level applied to some basis have no intuitive meaning in and of themselves. But also, there's a problem in finding an appropriate basis on a dynamic business like interest-sensitive universal life or SPDAs. It's tough to take a factor, apply it to a basis, and have it meaningfully capture all the nuances of variations in persistency, expenses, credited rates and everything else that has occurred in past periods to bring you up to the current valuation date and have all of the elements of the gross profits trued up appropriately. You could just completely redo your model by truing up the assumptions and then you end up with a factor that's different. But again, it has no intuitive meaning, and it's very cumbersome to do. You have no real comfort that once you've done it that the factors are correct. There's nothing intuitive about a factor.

On the other hand, many companies are going to a worksheet method, where they are looking at products by issue year and using a model that will project the elements of gross profits or deferrable expenses. Aggregating those up, plugging them into a spreadsheet, and then calculating the DAC amortization provides you with large aggregate numbers at a level that a product is being managed. It provides management information at the same time it gives you some intuitive comfort that what is going on makes sense or doesn't make sense.

This booklet addresses a number of different items, including management issues and some problems that may have been seen at the implementation and classification of products, and treatment of various types of products. At the time that this survey was conducted, the primary management issue really related to the fact that companies were not yet using *SFAS 97* information for product management. They were just doing it because they had to do it. They were not really ready at that time for unlocking. I think this is another area in which companies, especially those that have gone to the worksheet method, have improved their processes. They have built in the unlocking process as a normal piece of the process, rather than having it something that's difficult and cumbersome to do. It doesn't end up being delayed for a period of time until it makes a bigger effect than it had to make. Instead it's being done on a routine basis as valuation periods roll on.

The other issue that is mentioned in here, that I think is still important, relates to the classification of products. *SFAS 97* products are not like traditional products in the

way that they're reported in the income statement. They do not show premiums as revenues. They show charges as revenues.

Likewise, in benefits, they do not show the full amount of the payment to the beneficiary or to the customer; they just show the differences from the account value, as far as benefits are concerned. What that means is that if you show on one income statement, or balance sheet, the combined effects of traditional business and *SFAS 97* type of business, it's extremely confusing, because the expense lines, interest earnings lines, investment income lines, and capital gains lines are all composites of two different types of business yet you have revenues in terms of premiums for one and charges for the other. Those are often on different lines in the income statement. But then the benefits are all aggregated together into benefits for insurance products and for annuity products; they are all lumped into one line. Consequently, without additional information, a user of that financial statement is left high and dry, in terms of understanding what's going on. They have to take on faith that the bottom line makes sense, because analytical measures of what type of return you are getting on your revenues or on your premiums are not really provided. Management of companies, on the other hand, have the opportunity for a great deal more insight, because they have those breakdowns and they're often given a line of business' financial results that are appropriate for the particular product. So, management should make use of that opportunity.

Now more recently, and not described in that booklet, we have conducted another survey of DAC practices on *SFAS 97* types of products. Unfortunately, we have not finished compiling the results. I am not able to provide any results for this session, but I have looked at a few of the company's returns, so I can give you an idea of what's going on. One of the things I have seen is that there's movement to the worksheet method. In terms of the types of things that we surveyed, we looked at what's considered a deferrable cost, how companies are setting their DAC discount rate, DAC amortization period, what they're doing about capital gains, the mechanics of DAC calculations, model construction, and unlocking, and the relationship of GAAP reports to other management plans, which is a hot button with me. I think that you ought to be taking the effort to reconcile your *SFAS 97* projections to your business plan, to your pricing, to your in-force business management, and to your long-term plan. It doesn't necessarily mean that they all use the same assumptions, but you need to understand how they interrelate, and how one supports the other.

I'd just like to jump ahead to one other issue and that's the treatment of capital gains, which has already been addressed a little. I wanted to get my two cents worth on it.

AICPA Practice Bulletin 8 is the guidance that says you have to include capital gains. It says that expected gains and losses from sales of investments related to universal life-type contracts should be included in the determination of estimated gross profits. It does not distinguish between credit-related gains and losses or gains and losses that are due to shifts in the yield curve. One of the things that makes a difference, is that *SFAS 97* limits the investment earnings, which would include capital gains under the AICPA's interpretation, to the level where assets equal account values. Now you may be managing your business where, if you get a large gain due to a shift in the yield curve, you're still attributing it to your business. But under *SFAS 97*, you're probably going to be replacing those high-yield assets that created that gain with

lower-yield assets, and it is that revised lower-yield that you're going to have to use in your projection of the estimated gross profits. So you really are trading future investment income for a current capital gain, and it really can cause a huge catch-up adjustment in your SFAS 97 reporting. On the other hand, credit related gains or losses typically would produce a one-time spike in earnings which is offset to some extent by the dynamic effect of unlocking. And they're replaced by similarly yielding assets.

Now another practical problem that you have with SFAS 97 is allocating capital gains, because asset segments are not usually equal to the account values. They're usually based on statutory segments which are different in amount. We've seen practices all over the lot in terms of the way that companies will try to shelter their interest-sensitive lines from capital gains so that they don't have unlocking effects. But it is pretty difficult to avoid in the end. You usually have some of the assets supporting a line that will have a capital gain or loss at some point.

MR. CLIFFORD A. LANGE: When will the most recent survey that's being completed be available to us?

MR. DARLING: At this point, it's a small survey that was conducted for the benefit of a group of companies that were participating. So it won't be generally published. However, if you have specific questions about specific topics, give me a call. I'm in the Yearbook, and if I can address it quickly I'll be happy to answer your questions. If not, maybe we can end up with a more extended discussion. But I'll be happy to give you the insights that I have on it.

MR. FRIEDSTAT: One of the observations that Howard made was how he adjusted on an interim basis because of realized capital gains. Craig's illustration brought out a point that I had seen with other companies. Many companies, especially when they are between an unlocking, use the amortization rate, the so-called K factor and just multiply that by the realized gains allocated to the line of business to determine the adjustment for the increase or decrease in DAC due to realized capital gains. Is that substantially the same as what you're doing? Sounds like your adjustments were a little more complicated than that. I think simply multiplying by a K factor should give essentially the same result.

MR. ROSEN: We made the implicit assumption that when we take a realized gain that we're not changing the amount of the profits, only the incidence of profits. Therefore, from the standpoint of DAC, we would just take our gross amortization percentage and multiply. But what we in fact did, and this is a little theoretical, is say that the realized gain itself is an amount that is discounted conceptually, where the yield rate is the yield on the assets sold. We have allocated a stream to a line of business where, when we measure the recoverability or the continued appropriateness of the asset, we're measuring it at a different discount rate. So we've taken that partial stream and we've discounted it at whatever the appropriate discount rate is. By doing that, we're saying that if we had the time to plow the impact of the realized gain into our profit flow, and we still measured recoverability the same way that we always did, what would that do to our present value of available profits? That's why we discount at a different rate. But in essence, once I've done that for a DAC line, I'm going to multiply the gross amortization percentage by that K factor.

