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WHAT DOES THIS MARKET-VALUE ACCOUNTING (MVA) REALLY MEAN?

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Market-value accounting is one of the hot topics that many actuaries would like to know more about. This session will provide the attendees with an overview of the history of MVA, statement of financial accounting standards (SFAS) documents that pertain to this issue, and implementation issues. There will be a brief overview of the liability methodologies because this topic will be covered in Market Valuation of Liabilities (see page 499). Finally, there will be discussion of some of the latest developments.

MR. DOUGLAS C. KOLSRUD: I'm the corporate actuary at AEGON USA. Joining me are two colleagues who I've been working with on fair-value accounting issues over the last six months. Ed Robbins is a principal at the Chicago office of Peat Marwick. Jim Hohmann is a principal at the Chicago office of Tillinghast.

This is a two-hour session; the first hour will be a presentation by the three of us. I'll start off by giving a brief overview of *FAS 115* by going through the nuts and bolts quickly to either refresh your memory or to give you a little background on it.

Jim and Ed will touch on some of the issues that have surfaced since the adoption of *FAS 115*. There has been much discussion within the industry and the actuarial profession. The securities and exchange commission (SEC) has also released statements on *FAS 115* and industry task forces have been formed. They'll relate some reactions to market-value accounting and express some of their own opinions. During the second half of this session, the audience will be breaking into four buzz groups. We've come up with four questions and we would like each group to focus on one of these four questions. We'll spend the last half hour wrapping up and talking about what the groups have been discussing.

I want to begin by going over some of the nuts and bolts of *FAS 115*. *FAS 115* is officially known as "Accounting For Certain Instruments In Debt And Equity Securities." Many people call it marking to market of certain assets. The official term used in the statement is fair value as distinguished from market value. I'll use the words interchangeably but the official term is fair-value accounting rather than market-value accounting.

FASB had some concerns when they were putting together a statement on fair-value accounting. First, FASB was concerned that financial assets were not being accounted for on the same basis across different industries. A bond that may be handled one way in a life insurance company may not be handled the same way in a manufacturing company.

A second concern applicable to some life insurance company assets, was that if you classified assets as *held for sale*, you held them at the lower of cost or market and such handling is one-directional. If the market value is less than the cost, you'd write down to market, but if market value rose over cost, you would not write up the asset. They didn't feel that the treatment of held-for-sale assets was even handed.

There are many members in the FASB that felt that fair-value information for financial instruments is much better just by its very nature. A historical book-accounting approach that the industries used since inception does not represent the fair value or the real underlying economics of the assets that have been purchased.

There are two other concerns: One is gains trading. There was concern by the FASB that companies would have the ability to sell assets when the market value is in excess of book and take a gain through their income, whereas they could hold on to assets that are under water and not have to recognize that gain for quite a while. There is some discomfort with the ability to manipulate your income statement and balance sheet. Finally, there was concern under the old system that the accounting for assets was based on intent. The value for which you held the asset on your balance sheet for one life insurance company versus another could vary for the exact same asset. If you wanted to call it held for sale, or if you thought it was a held-for-sale-type asset, you could account for it on a lower cost to market whereas another company or most of the companies would be accounting for it on a book-value basis.

As you'll see, *FAS 115* has done a good job of resolving the first two concerns, it partially has resolved the third concern, but falls short of resolving the final two.

Enterprises that are included under *FAS 115* are both financial and nonfinancial institutions. Anybody that's holding these types of assets on their balance sheets has to comply with *FAS 115*. It's not just a bank and an insurance company requirement. Both depository and nondepository financial institutions have to comply. There was some discussion during the exposure period that perhaps life insurance companies, because of the long-term nature of their liabilities, should be exempt and that FASB's intent was for this to apply to banks with short-term liabilities. But in the end, that argument was not accepted, and *FAS 115* does apply to all financial institutions.

There's no exemption for small companies. So big or small, you need to comply. Not-for-profit organizations are exempted. The FASB is going to cover not-for-profit institutions in the future in a broader-based statement. Finally, certain industries that account for assets at market already, for example, broker dealers, are also exempted.

When do you have to start doing this? No later than the fiscal year that begins after December 15, 1993. For companies that account on a calendar-year basis, it's applicable January 1, 1994 or by the time you file your first-quarter financial statement. However, you were allowed to adopt as of December 31, 1993 if it hadn't already been filed. With some of the uncertainty that took place in the first half of the year, I think the number of companies that adopted lessened as people began to file their financial statements.

Which financial instruments are included or excluded? *FAS 115* defines two types of securities that are included under the statement; debt securities and equity securities. Debt securities include treasuries, other agencies, bonds (both private and public), securitized assets (collateralized mortgage obligation (CMOs), pass-through mortgage backed securities, and some of the other derivatives that are on insurance company balance sheets). It's interesting to note which debt instruments are not included. Consumer loans, residential loans which have not been securitized, policy loans, and commercial loans (if they've not been securitized). You can see that, for life insurance companies, a fairly significant percentage of assets are included because a substantial amount of the industry's assets are in corporate bonds and the like.

Which equity securities are included? Common and preferred stocks, options, warrants, and mutual funds for which you can readily get market values. Partnerships and closely held companies would be excluded. What's probably most important to us is that financial liabilities are excluded. There's no provision to mark the liabilities to market in *FAS 115*. If you read through the text of the statement, FASB says that it was unable to identify an approach that was considered workable and not unacceptably complex. I think that in the end, there really wasn't one method that came forth, and, as the other speakers will present later, you'll see that multiple methods exist. FASB made a decision addressed specifically in numerous paragraphs, that it wasn't essential to address the valuation of liabilities in this statement. It clearly was not ignored. It was thought through and, in the end, decided that it was better to proceed with *FAS 115* than not do anything at all.

There's an interesting point back in the discussion of the statement that says, an interim solution is appropriate at this point. I'm not exactly sure what to read into that, but I think it recognizes both on the asset side, because not all the assets are included, and on the liability side because they're all excluded, that there are weaknesses in this statement and perhaps FASB will be revisiting this in the future.

The statement classifies assets into three categories. One is held to maturity. These are what you've been accustomed to over the last several years. Held-to-maturity assets continue to be reported at amortized cost. There are also trading assets. They will be reported at fair value, and the change in the unrealized gain and loss account will run through earnings above the line. Finally, available for sale will also be reported at fair value, but rather than reporting the change in the unrealized gain and loss account in income, that adjustment will be made through shareholders equity.

Let's go to each one of these in a little more detail. With regard to the *held-to-maturity* category, if you read the statement, it's very clear that the requirements to put assets into this category are very strict. You must have both positive intent and the ability to hold securities to maturity. Not only are you required to go into it thinking that you'll hold it to maturity, but you also must have the capability to avoid selling them.

Held to maturity assets cannot be sold for the following reasons and still be called held to maturity. Changes in market interest rates. Changes in a securities prepayment risk. If interest rates are moving and prepayments are speeding up or slowing down, and if you've classified the asset as held to maturity, you're not allowed to trade that asset. If you have liquidity needs. If there's an up tick in surrenders and

you have assets classified as held to maturity, then you're not allowed to sell those assets. If you think investment spreads or yields in different classes of assets will change, you're not allowed to sell those assets and reposition the portfolio if they're in the held-to-maturity category. So you can see there are many good reasons to sell assets that are not allowed if you are classifying assets in the held-to-maturity category.

There are certain reasons that you can sell assets and not taint the held to maturity group. Ed's going to go into this in a little more detail, so I'll click through them pretty quick here. If you anticipate, or you have evidence that the credit worthiness of the security is deteriorating, you can sell the asset. You don't have to be the last one holding the worthless bond. Second, is a change in tax status of security. Ed will go into that in quite a bit more detail. I think an interesting one is changes in risk-based capital (RBC). RBC requirements for a certain security would be a reason why you could move the asset out of this category and not taint the whole group.

Trading securities are assets that you are buying and expecting to trade them in a very short period of time. They are probably not the types of assets that are that commonly held by life insurers.

The catch-all category is the available for sale. The way it's been defined in the statement is it's assets that you don't put in either the first two categories. The speakers following me will talk a little bit about what companies are doing and what categories these assets are being put into.

There are certain rules, or certain accounting treatments that you have to follow if you transfer assets between categories. In general, again, you really aren't supposed to be moving assets between categories. Moving in and out of the trading account is supposed to be rare. If you had an asset in a trading account and you move it to either the held-to-maturity or the available-for-sale category, there will be no immediate impact to the balance sheet or to the profit-and-loss statement. Since it's sitting there at market or fair value, you move it at fair value and it will take on that new cost basis in the category that it goes to. If you move assets from the held-to-maturity category or the available-for-sale category into the trading category, the gain or loss that is sitting in the account at that time (the difference between the amortized cost and the fair value) will be taken into income immediately. If you go from available-for-sale to the trading category, there's no immediate impact to equity because you've already taken that difference into the equity account. You would now take the difference into the income statement.

Another transfer that should be rare is moving from held to maturity to available for sale. At that point in time, the unrealized gain or loss that you would be sitting with in the held for maturity category would go through the equity account as would any other available for sale asset.

The final possibility, and probably the one that would be allowed the most, would be a move from the available-for-sale category to the held-to-maturity category. At that point, you'd be sitting there with an unrealized gain in the equity account. When you moved the asset between categories, the asset would continue to be held at the current fair value. When you move it, it would move at fair value, but you would

have this unamortized equity component sitting there that you would need to amortize into income over the life of the asset as you would the premium or discount on the amortized cost method.

Another statement that was adopted, *FAS 107*, is a disclosure statement that applies to assets and to certain liabilities for life insurance companies. Companies have to disclose fair value of liabilities for such things as single-premium deferred annuities, guaranteed investment contract (GICs,) and universal life.

There are four basic methods that have been used in the past for calculating the fair value for these liabilities: cash surrender value, account value, discounted cash flows, and traditional purchase accounting appraisal techniques. You can see that there's quite a diversity in practice, and I think it shows some of the issues that we'll have to address if we ever get to a point where we use fair-value accounting in the actual financial statements.

With that I'll turn it over to Jim Hohmann, and he'll fill you in on some of the recent events.

MR. JAMES E. HOHMANN: I am from Tillinghast in Chicago, and the reason I am speaking here is because I also have the job of chairing an Academy Task Force that is studying the fair value of liabilities issue.

Let me start with several disclaimers. The first disclaimer is that I am not going into much depth. The reason for that is to avoid overlap with another panel discussion, I believe it is number 49, which should address these issues in a little more depth. So I will just survey some of the points in deference to that panel.

The second disclaimer is that statements I make about the Academy of Actuaries Task Force on Fair Valuation of Liabilities (FVL) are my own. I am not making any statements on behalf of the Academy or the Task Force.

Let me start with a brief recap of a couple of items that Doug already talked about.

My presentation begins with a short recap of *FAS 115*. Following that, I will talk about some implementation issues. Those will be primarily issues that have been raised in discussion as opposed to literal implementation, because only a few companies have actually filed statements, at this point, under *FAS 115*.

Many companies are simply mulling over what the considerations are, etc., particularly mutual companies that are currently in the process of moving to generally accepted accounting principles (GAAP).

I also will talk about the Academy of Actuaries Task Force. Specifically, I will tell you what we have been doing, describe how we are organized, and apprise you of early findings.

FAS 115 came out in May 1993. It followed Exposure Draft 119-A. When 119-A came out, it caused quite a stir. The Committee on Life Insurance Financial Reporting of the American Academy of Actuaries actually went so far as to testify before the

FASB. First they wrote a letter and then testified before the FASB on the topic. Basically, the committee stated that it would like to see some kind of consistency in accounting, be it book to book, market to market, whatever, but they wanted some form of consistency.

That scope of *FAS 115* has already been covered by Doug. Briefly, it is financial institutions, and in particular, securities held by those institutions. We are not talking about mortgages. The effective date is for fiscal years beginning after December 15, 1993. Again, this is repetitious, but it is important to bear in mind because the dates are coming upon us.

FAS 115 provisions separate assets into three categories. I usually think of it as four. Held to maturity has been explained as those assets that are subject to book accounting. Available-for-sale assets are subject to fair-value accounting with the fair-value changes going through equity, but not income. Trading securities are subject to fair-value accounting, with the unrealized holding gains or losses going through income. The fourth category is basically all of the assets that are not covered by *FAS 115*. They continue under book accounting. For example, there are mortgages.

Let us move on to implementation issues. Asset categorization is one of the first sets of decisions that needs to be made under *FAS 115*. Early this year, I did a little bit of ad-hoc surveying on this question for a professional speech. I called a number of companies and I have to admit that in my particular sample I had a bias toward companies that were fairly high profile on the stock side. Furthermore, they also tended to be large annuity writers. Consequently, they would be very cognizant of asset/liability issues.

When I did my informal survey, however, I found an overwhelming majority, perhaps 90% or more, of the assets were going to be categorized as available for sale.

Since then, the American Council of Life Insurance (ACLI) has done a survey that included different absolute findings but had the same general message. In their survey, they found that, in the aggregate, 55% would be available for sale. I believe 36% were being held to maturity, and 9% were showing up as trading securities.

That is obviously quite a bit different from my findings, but it is consistent that more than half the asset value was showing up in the available-for-sale category. I think Ed Robbins is going to share some other findings. So the plot thickens here a little bit. The key message, though, is that available for sale is going to be a significant category, and therefore, the attributes and treatment of available-for-sale assets are quite important for consideration.

SEC staff has stated that unrealized gains and losses in the available-for-sale category should effectively hit the balance sheet as if they were realized. That means they should be tax-affected. It also means that things like the deferred policy acquisition cost asset should be adjusted, because it would have been adjusted if a gain or loss were in fact realized. For example, if you're dealing with *FAS 97* business where estimated gross profit streams are established, those estimated gross profit streams

presumably would be revised to reflect these holding gains or losses in the available-for-sale category. As a result, you would have amortization accelerated or decelerated with unrealized gains or losses.

That tends to mitigate the effect of the changes in unrealized gains or losses, and their impact on equity. So with these mitigating effects, one coming from deferred policy acquisition cost (DPAC), and more coming from tax affecting, you can see that equity swings will not be as wide as originally thought.

During the Orlando meeting, Jim Wallace cited a study he made of financials where *FAS 115* has already been implemented. I will share a couple of his findings. He brought to the table a couple of examples that I'll repeat. In one company, he found that 22% of the effect of unrealized gains or losses had been mitigated through changes in the DPAC. Additionally, he found that something on the order of 26% had been absorbed through changes in deferred tax. Another 3% was attributed to other causes. I will discuss other causes in a minute, but it is noteworthy that 51% of the effect mitigated in that particular company.

In a second company, 35% was mitigated through DPAC. Something like 23% was offset by deferred taxes, and less than 1% came from other causes. With rounding, I believe that added up to about 58% mitigation. So again, it was quite substantial. As a result, some of the push that existed earlier for things like fair value of liabilities has subsided somewhat, but still remains. Note that the differences between the two companies would relate to things like how large is their available-for-sale categorization? What is the nature of their underlying products? How large is the DPAC, etc.? So there are many variables involved. Even though these numbers are interesting to look at, it is difficult to say whether we should note them as representative.

Other potential outcomes from *FAS 115* coupled with statements made by the SEC staff are that you could have an anomalous resulting "unrealized loss recognition." Think about that for a minute. If you had a situation with an unrealized capital gain in the available-for-sale category, you might conclude that reinvestment rates would be lowered (under the assumption that falling rates of interest gave rise to the unrealized capital gain).

If you were doing loss recognition testing using gross premium valuation techniques, you would correspondingly lower the gross premium valuation discount rate. Therefore, the gross premium reserve would increase over what it would otherwise be, and you may find the net GAAP liability is inadequate. That would leave you in the strange situation of posting unrealized loss recognition. While it may be odd, it is at least mathematically possible. Whether or not it will be forced is unclear at this time.

Another interesting discussion point has been something called liabilities for total return crediting. In this case, the SEC was addressing contracts where you contractually pass on investment experience to the contractholder. For example, if you had an unrealized capital gain, you should establish a liability for the fact that ultimately you would credit the gain to contractholders. The idea is that it would be inappropriate to distort your balance sheet by showing increases in equity for the unrealized capital

gains when, in fact, under your contractual obligations, they would go to the contractholders.

One can extend that thinking to a situation where you might have had interest crediting strategies that were routinely passing on capital gains or losses. I am not suggesting that companies employ these strategies, but if they did, a logical extension would be to establish accrual items for these unrealized capital gains under the argument that they would ultimately be passed onto the contractholders.

Another possibility that occurs to me, and perhaps Ed will comment on this, exists under the new exposure draft statement of position (SOP) 135-A for participating contracts. It seems that accruing holding gain liabilities would apply in cases where capital gains are used to fund changes in dividend scales. Under this line of reasoning, holding gains in available-for-sale securities would affect accounting for traditional participating policies under the 135-A SOP.

In a practical sense, this means you must maintain two sets of books. Ed will elaborate more when he discusses shadow deferred acquisition cost (DAC) asset. I have also heard it referenced as imaginary DAC or SEC DAC.

Let me move to the Academy Task Force. This will be fairly brief and let me emphasize that these are my own opinions. This is not an official statement by the Academy.

The task force was formed in January 1994. Our charge is to assume we have a clean sheet of paper when someone poses the question of fair valuing liabilities. As a result, we have not constrained ourselves within the current accounting literature. Instead, we tried to approach the question primarily from an academic point of view.

Our objective is to research methods and develop a white paper. In the white paper, we will try to establish qualitative balance sheets on potential methods. We organized ourselves into three subgroups. One was to study actuarial appraisal methodologies, another was to study option-pricing techniques, and a third was to study secondary markets.

Originally, we hoped that the reinsurance markets would be thick enough to provide useful information. However, the secondary markets group has concluded that they are not, and as of a couple of weeks ago, that subgroup was reassigned to support the other subgroups.

The actuarial appraisal subgroup is headed by Ed Robbins who is right here. The option pricing subgroup is headed by Bob Reitano.

The actuarial appraisal subgroup has looked at a few methods beyond pure actuarial appraisal, but that is the only one I will talk about, assuming that panel discussion 49 will hit others. Basically an actuarial appraisal values the bundle of assets and liabilities. This is true in the case of a block of business appraisal, for example.

An interesting and related point was made when the Academy addressed the FASB about Exposure Draft 119-A, the precursor of *FAS 115*. During that presentation, a

FASB board member asked whether or not fair values of liabilities would vary depending upon the underlying assets. I was not there, but I understand that a positive answer was given and that the FASB found that disturbing. Nonetheless, it is generally true under actuarial appraisal methodology that a change in the underlying assets will change the resultant value.

Mechanically, the fair value of liabilities would be a residual value computed before federal income tax by deducting the fair value of assets from the value of the bundle computed using actuarial appraisal techniques. Note that in order to use this method, the fair value of assets must be available.

A positive attribute of this method is that it is anchored in actuarial literature and pricing. Furthermore, you could even lever some existing models, for example, those used for cash-flow testing.

Turning to option pricing methods, one of the things that we noted quite early on is that option pricing is very complex. It also has some limiting assumptions. It typically requires arbitrage-free interest scenarios and assumes an efficient market. A positive attribute of option pricing is that it can potentially allow some decoupling of assets and liabilities—an objection raised by the FASB to actuarial appraisal methods.

The idea here is that if credited rates were linked to some kind of external index, option pricing could value liabilities without regard for the underlying investment portfolio. I am not suggesting that insurers do or should operate in this fashion. I am merely observing that the decoupling is possible.

Our investigation of option pricing began with lattice models. From there we talked about scenario-based models, discounting spreads—option adjusted spreads (OASs), policyholder behavior, company behavior, and then valuation methods. I will talk a little bit about all but the last of these.

Lattice models require the development of arbitrage-free yield-curve lattices. A drawback of lattice models is that they are not very good for path dependent cash flows. The reason for this is obvious when one visualizes a lattice. From any future node on the lattice, one is unable to identify a unique path from the origin to that node.

For example, since the lattice is closed, any one of several paths could have ended at the current node. This indicates that the liabilities at that node might have been exposed to very different interest rate environments in reaching the node. Given a path-dependent cash-flow sequence, one is unable to make a satisfactory valuation because no information exists within the lattice to tell us what interest rate history has affected the liability.

Another drawback of lattice models is that they are rather computationally intensive. As you move through lattices, the number of points or nodes becomes rather large in the short run and unmanageable in the long run.

Another form of the option-pricing model is the scenario-based model. These models also generally require arbitrage-free scenarios, but they are useful for path-dependent

cash flows because you can actually trace a unique path from the origin to any future point in the scenario. Consequently, you know the interest rate environments that the liabilities have been exposed to and you can model their effects upon cash flows. For example, you might have different excess lapses occurring, etc., depending upon the particular path that you are following. Again, however, this is rather computation intensive.

Assuming your have done the projections of cash flow, discounting is necessary. We identified several schools of thought as to how OASs might be derived for this purpose. One approach would be to discount at the company cost of debt. Perhaps that is a proper option-adjusted spread to be used for the liabilities. It could, however, be a bad answer because the cash flows rated for debt purposes are generally subordinate to policyholder obligations.

Another view might look at the option-adjusted spread on the underlying assets. Again, we thought that could be a bad answer because the assets may not have much to do with the liabilities. It depends on how diligent the company is in managing that relationship.

A third approach is cost of funds. To understand this method, picture a brand new issue projected over multiple scenarios. One would depict policy and company behavior in those scenarios. If one computed an OAS that causes the average present value of future cash flows to equal the net cash flow at issue; this should be the cost of funds (financing). We think this may have some merit.

Another method would impute a quality rating for the organization. For example, if a particular organization has a AAA claims-paying rating, perhaps a AAA OAS should be used in discounting liabilities.

In addition to OAS, we worked on policyholder and other behavior models. There were no particular surprises here. We are talking about book values on surrender, premium patterns, policyholder loan utilization, etc. On the company side, we discussed crediting strategies. Are they going to adjust them over time? How dynamic will they be, etc.?

Finally, a few practical issues. Model validation is always something that we like to do as actuaries. In the financial markets, users of option pricing models can actually look at market values and they can validate their models. But our basic problem is that we don't have a thick market. As a result, validating our models will be difficult.

Incidence of profit is another important item, and this goes back to the option-adjusted spread. Determining or redetermining OAS will have a tremendous impact on the timing of earnings (if fair valuation of liabilities is used for reporting purposes).

Another practical issue is integration with *FAS 115*. While this is outside the scope of our work, it would have to be considered in depth if fair valuation of liabilities became a part of financial reporting. Finally, there is the question of objectivity of assumptions. A very large number of assumptions are required in these projections, and auditors would need to assess their reasonableness.

MR. EDWARD L. ROBBINS: I'm with KPMG Peat Marwick. I'm also a member of the Task Force on Fair-Value Liabilities (FVL). Like Jim, I don't speak for my firm or for the FVL group. I'm going to wrap around what the first two speakers have said, by talking around the edges, editorializing a bit, and talking about some of the criticisms we're seeing of the way *FAS 115* has been put together.

It's easy to take pot shots at *FAS 115*. And I don't really mean to be at all disrespectful because the FASB does consist of smart people. It's just that *FAS 115* come about in a very difficult and politically charged atmosphere.

I'll go ahead with some of the major critiques. The available-for-sale category is the primary problem for insurance companies. The trading category is typically small in insurance companies. There is very little or nothing in assets in that category. Available for sale is the major one. There are some questions on whether an asset is completely exempt from this categorization need. In Jim Hohmann's "fourth" category, there are some questions about, for example, private placements that are not backed by real estate. Where do they belong? Are they in or out of this categorization requirement? So *FAS 115* did not address all the gray areas around this categorization requirement issue. There is one troublesome note here. At each reporting date, you're supposed to reassess the appropriateness of the classification you make for an asset. What does that mean? We're not exactly sure, because Paragraph 15 says that the only "nonrare" category change should be from available for sale to held to maturity (HTM). Every other transaction, in and out of a trading category, or from held to maturity, to available for sale, should be isolated and rare. Well, you put that together with the fact that you're supposed to frequently reassess the appropriateness of a categorization of an asset and you have a little bit of a contradiction. And I'm not sure how to deal with that.

As the two speakers before me have said, once you classify an asset as held to maturity, you've locked it in. You can only change that categorization for one of six reasons. I want to focus on the first two out of the six reasons you can use to get rid of an HTM security. Credit change is one. It actually is, *evidence*. Evidence of significant deterioration in an issue as to its creditworthiness. Well, what does that do to the worth and value of an astute investment advisor? Investment advisors have prided themselves historically on their ability to look down the road at what's happening to a company and what's happening to an industry. Well, you can forget about the investor's advice on anything that you put into the held-to-maturity category because once you've put it in there, he can't do anything with it. So you're paying him all that money to be a shrewd manager, but it's wasted.

There are two comments I'd like to make on the tax law change. One is that you're allowed to affect a change of category for a tax law change if it goes from exempt to taxable. But I think what was missed is they didn't make the connection that a change from tax exempt to taxable is merely a special case of a change in marginal rates. And a change in marginal rates is specifically excluded from that exception. So it's really difficult to say how correct or equitable that rule is. Quantitatively, given the high policyholder share percentage in most life companies, these two types of changes in the tax environment are really not far apart at all.

In addition, many, if not, most companies in the mid-1980s were confronted for a while with the alternative minimum tax (AMT) system. When you're confronted with the AMT system and the regular tax system, tax exempts all of a sudden become in effect taxable at 75% add back. Even today small companies can still be subject to AMT. This particular provision, a change in the tax status of an asset, was not elaborated upon sufficiently to take into consideration the two different tax systems that a company can be operating under. Those are the only two exemption reasons out of the six that I wanted to talk about in terms of editorializing and doing the gadfly work, the critiquing.

There is a possible catch-all category under which you can sell a held-to-maturity asset. It's not well-specified. It basically says that there are possible sales that won't throw the company's categorization into question. Specifically, isolated, nonrecurring and unusual events that could not have been reasonably anticipated, can cause the sale of HTMs without calling into question the intent to hold other debt securities. Note the words *isolated, nonrecurring* and *unusual*. There should not be many of them. And further, once you actually do get rid of a held-to-maturity security, whether it's isolated, nonrecurring or unusual, or whether it's one of the six "outs," you must do some reporting. You must report the amortized cost, the related realized or unrealized capital gain or loss, and the circumstances leading to the decision to sell or transfer the security. It's all in *FAS 115*. And, to reiterate, such transfers or sales should be rare.

Let's continue with some of the editorializing. *FAS 115* was passed by the FASB in a five to two vote, indicating that there was a bit of controversy at the FASB board level. But the two dissenters were really no friends of the industry. They wanted fair market value for everything. In addition, they felt that all unrealized holding gains and losses should go through GAAP earnings. They felt as long as there was a significant block of assets whose change in market value was not going through GAAP earnings, you would continue to have gains trading going on and that it wouldn't stop this abusive practice. In Doug Kolsrud's words, it really does not stop accounting by intent.

Next observation. Any company with trading account market value unrealized holding gains or losses, must put it in income. Companies might consider putting the trading portfolio under their *FAS 97* liabilities, or under their (soon to be) GAAP for mutuals SOP for participating policies. You'll generate in earnings a DAC offset to those unrealized gains or losses by doing so. Additionally, as everybody is well aware, a major objection on the part of the actuarial profession was that there was no comparable change in the market value of liabilities. That's what the FVL task force is all about. This is such a fundamental issue that it's very difficult for an uninitiated actuary to understand how the FASB board could have been so intransigent on this issue.

FASB's basic reason as stated in the "Basis for Conclusions" section of the statement was that any solution raised was either unacceptably complex or permissive. Additionally, there was some dissension among the respondents at the hearing, one source of which was whether there should be a cash-value floor on the market value of liabilities or not. Another element was whether FVL should be linked to the specific supporting assets.

We're running a little bit short of time. I'm going to proceed to a couple of other very quick items. I want to talk about the fact that this may end up making life insurance company stock prices more interest sensitive. And in support of that, I just want to give you a couple of quotes. I'll read from a newsletter from Fox Pitt Kelton, an investment banking firm. It's dated May 23, 1994. Whether you agree with it or not, it's interesting to hear the firm's perspectives. "The industry has now fully adopted *FAS 115* as of 1994 first quarter. The companies that mark their bonds to market (net of taxes and DAC offsets) have reflected the impact and book value. The industry has included about 75% of its portfolio in 'Available for Sale' on average." This 75% is a little bit different from the 55% that Jim quoted from, I believe, the ACLI source.

MR. HOHMANN: Right.

MR. ROBBINS: To continue, "The percentage is far too high in our view. And it comes at what might be the worst possible time as interest rates are rising." [Interesting.] "On an economic basis, assuming 100% of asset portfolios marked to market and no ability to mark liabilities to market. Each 100 basis point increase in interest rates equates to about a ten to 11% reduction in GAAP book value for the life group on the average." [Interest effect factor.] "Twenty-five percent of the Fox Pitt Kelton universe of forty life companies already had bond portfolios under water at quarter end. Given that rates have increased another forty or fifty basis points since quarter end, the life industry's total bond portfolio market value has now moved below cost." That's what they're saying.

Just a couple of more quotes from this: "Under *FAS 115*, as bond markets go below cost, [I think they mean book value] two restrictions come into play. First, DAC can only be restored through original cost." [That may no longer be true, by the way, and I'll get into that in a moment.] "Second, the tax offset can only be used to the extent that unrealized losses can be offset with realized gains over the three previous years." So you have an accelerating effect of decline in value when your bond values move below amortized value.

The last item I want to quote from here is their following opinion. "We are more favorably disposed to those companies which allocated around 50% or more of their portfolio in held to maturity, while managing predominantly interest-sensitive books of business." [They mention about seven or eight companies.] "This implies products with good persistency, surrender charge features, a balanced product offering, controlled distribution, and a well matched portfolio, all other things equal." I presume those companies did some cash-flow testing on their portfolio; their assets and liabilities were reasonably matched, and they felt that under stress type conditions they really could sock away a large amount of held-to-maturity assets as a rather high percentage of their total asset portfolios.

Let's proceed now to the fascinating subject of the shadow deferred acquisition cost (DAC). The SEC, in a public forum in January indicated its concern that it was important to offset any net unrealized holding gains by a so-called valuation allowance. The valuation allowance is what you would call your primary traditional DAC versus a DAC that counted unrealized gains and losses in its gross profit stream under *FAS 97* products. And, of course, if you count unrealized gains, you're going to

accelerate your profits, and you're going to have future unrealized losses as bonds head towards maturity later on. So what it does is have the effect of accelerating gains and accelerating DAC amortization. And if you put the difference between the primary DAC and the shadow DAC into that separate component of shareholder equity where the unrealized gains go, you end up generating a fair offset. And the offset for major *FAS 97* companies, for example, the major annuity writing companies, can easily be more than half of the entire unrealized gain. Much of that has evaporated in the last four months, as most of you know.

Anyway, the SEC official that made this public announcement indicated that this valuation allowance was necessary in order to avoid overstatements in a company's GAAP net worth. They didn't elaborate much on the issue, so they left the industry pretty much to grapple with the details as usual. Anyway, it applies right now to only *FAS 97* business, in other words, unrealized holding gains and losses on assets supporting *FAS 97* business. However, with the GAAP for mutuals issue nipping at our heels, it's going to bring in a major additional segment of assets as well that will be subject to a shadow DAC. The participating portfolios will have to generate expected gross margins and, thus, will have to generate unrealized gains and losses in shadow DAC margins.

What do you do about prospective assumptions when you're putting the estimated gross profits (EGP) or expected gross margins (EGM) stream together? If you have a large positive shareholder equity component, large positive gains, they're going to either revert to losses, or you're going to sell them and reinvest into a lower interest rate market. So you have two things that go in the same direction to accelerate your gross profits and bring your shadow DAC down.

Jim mentioned a new issue that's come up with several clients. It's the allegation that for some of these unrealized gains and losses you can put up an additional policyholder liability, and that liability may offset the need for the shadow DAC. One might possibly find support for that type of conclusion.

One of the most interesting things about the shadow DAC is that it lends itself to some reasonable approximation techniques. You can pretty much take your unrealized gains as you get them and multiply that number by your weighted amortization percentage, that is, your weighted expense premium percentage which gives a rough approximation to your valuation allowance. In other words, that is the difference between the primary DAC and the shadow DAC. I will not go into detail here. There's an article in the March 1994 issue of the *Financial Reporter* that describes the approximation and gives both a proof and an illustration.

I'm going to finish up with the fact that the SEC very recently indicated that it is now willing to consider reversing their stand of last January where they had disallowed the DAC offset for net losses. Up till about a week or two ago, the SEC said, yes, you must establish a valuation allowance when there are unrealized gains, but you cannot do that for unrealized losses. It has now shown a willingness to modify this position. It is basically saying, yes, you can make the valuation allowance symmetric. Again, the adjustment must be computed as if the losses had actually been realized. And second, you cannot restore your DAC beyond amounts originally capitalized. In other words, your shadow DAC at a time of net unrealized losses would probably be above

your primary DAC, but it can't be above the amount initially capitalized. Not a terribly unconventional thing for the SEC to say.

It concluded that it intends to go ahead with this modification of its stand. When and how it is going to announce it is still unclear; perhaps it will issue a notice to the Emerging Issues Task Force in June or July. So this could be a very important issue in the event of a further interest rate spike. So stay tuned.

MR. KOLSRUD: We're now going to break into our buzz groups. We've come up with four major questions, and what we'd like to do is basically split up so that each section focuses on one of the four questions. The first topic is a discussion of what you considered when putting assets into the categories: held to maturity, available for sale, and trading securities.

The second topic is the methodologies that can be considered or used for different products under *FAS 107* disclosure of fair value of liabilities.

Issue three is what are some of the adjustments that can be used in conjunction with *FAS 115,* such as shadow DAC, tax, policyholder liabilities, and what are some of the implications or challenges with these adjustments?

The remaining topic is to discuss what methods might be available if we were to go to fair value of liabilities methodology, such as some of the things that Jim touched on that the task force is working on.

Take about 25 minutes to talk about your assigned issue, and then designate a spokesman for each group. For the remaining time, we'd like to have the spokespersons come forward to summarize briefly, in a minute or two, some of the issues you talked about. We'll have each group do that, and if you're the second group on a particular subject, you need not repeat everything the first group said. You can say we agree with what they said, or whatever. We've got nine groups and we'll have about 25 minutes, so that's two-and-a-half or three minutes per group.

MR. KOLSRUD: We're going to let the designated group leaders or spokesperson come up and summarize their discussion. We can start with number one.

MS. B. DALE MATHEWS: We have about five points. One was just a thought that maybe the difference in the survey results was related to the fact that companies were realizing the possible mitigating impact on the DAC and so they thought they would move more of their assets into the available-for-sale category. It was just a thought.

Regarding the issues that might be taken into consideration in deciding upon category, one of them was possibly the pattern of liability cash flows. And if you had a product like an immediate annuity (IA) where the future cash flows were quite certain you might hold those assets in held to maturity. For something like universal life where there's a potential of large amounts of surrender or something, you might want to put it in the available-for-sale category.

Another point was to look at the actual assets to be moved. Would you have capital gains associated with the offsetting capital losses or would you prefer to move the ones that had capital gains associated with them?

Another thought was just management's ideas of where interest rates were going to go and the future capital gains or losses that might result.

And our final thought was in dealing with the auditors. How flexible would the auditors be and what might they allow us to do?

MR. KOLSRUD: The next group. Do you want to followup with additional comments?

MR. DANIEL S. CRAINE: We had some of the same points that were just mentioned. In addition, we said that we felt that the held-to-maturity category was too stringent. It was not flexible enough and that it made it undesirable. For instance, a company might be able to say that overall if the plans hold 59% of the assets to maturity, they could not identify those assets which will mature and, therefore, which were the classings available for sale.

There was also a time constraint. If you were planning to hold an asset for ten years, it could not be considered held to maturity if its maturity was longer.

We also thought that a driving force ultimately would be what the stock analyst expected. If the stock analyst was expecting to see 50% available for sale, companies would feel the pressure to classify the 50% that's available for sale. Therefore, this is an accounting rule that could change the way the business is done.

A question that we had was regarding changing assets from held to maturity to available for sale based on the evidence of the deterioration of credit rating. Is that a change in credit rating? Is it positive or negative or just a deterioration?

MR. CRAINE: One of the criteria for taking an asset out of the held-to-maturity category into the available-for-sale was deterioration of credit rating.

MR. ROBBINS: Yes.

MR. CRAINE: Would that be a change either way or just deterioration?

MR. ROBBINS: I believe it says deterioration. I don't know the answer with respect to upward changes in quality.

MR. KOLSRUD: That's the way I read it. You don't have to wait until the very end to sell it. If you see that the value is going to drop dramatically or deteriorate, then you can get rid of the asset before it drops.

MR. ROBBINS: The way it actually reads in the statement is evidence of a significant deterioration and the issue is credit worthiness. I think the two key words are *evidence* (you know exactly what that means) and *deterioration*.

You can always move from available for sale into held to maturity. That does not appear to be restricted. If there's an upward change in quality in a held to maturity asset, what are the incentives to move it from held to maturity to available for sale? I guess the answer is, to capture the increase in market value. Is that it?

FROM THE FLOOR: Yes.

MR. ROBBINS: That's interesting.

FROM THE FLOOR: Yes. I hadn't thought of that either.

MR. ROBBINS: Or you can move it into trading and get it into GAAP earnings.

MR. KOLSRUD: We have one more group that covered question number one.

MR. ANTHONY S. BELISLE: We agree.

MR. KOLSRUD: Next time we'll make you group number one.

MR. BELISLE: Actually, we discussed two other things. First, your tolerance for income statement fluctuations. If you want to put it in the trading category, you're going to have to be able to be more tolerant of the fluctuation of your income statement.

And the other thing we mentioned was the tolerance for surplus fluctuations. If you're going to put in the available-for-sale category, you're going to have to be a little more tolerant on your surplus fluctuations. So there are considerations such as risk-based capital (RBC), the rating agencies, the size of the company, and liquidity.

And the other ones are: nature of liabilities, types of assets, investment strategy.

MR. HOHMANN: I had one comment. I don't think this was mentioned, but it seems to me that it is important to make sure that you have a fairly explicit linkage between how you classify investments into held to maturity, etc., and how you structure a liquidation strategy for cash-flow testing. For example, you would want to make sure that held-to-maturity assets were at the end of the line for liquidation.

MR. KOLSRUD: What about administrative issues with investment accounting systems? I know our investment people at our company were not excited about keeping track of these separate types of assets and different pools, what are they matched to and things like that. I know that was a consideration we brought into play. I want to skip number two and come back to it. Let's move on to number three.

MR. MARTIN R. CLAIRE: Our discussion of the mitigating factors didn't go too far because we were all either mutuals or regulators. But in terms of the idea of mitigating factors, the idea of waiting to see how they play out as to whether or not *FAS 115* is as bad as everyone thought, appealed to us, especially as mutuals. You know, we can sit back and wait over the next two years to see what happens, and the idea of fair value of liabilities is something that might make things worse,

depending on how that method works out. Maybe things aren't as bad as we thought they were.

The way to categorize the problem in number four isn't fair value of liabilities per se. The problem is to find a way of preventing your surplus from fluctuating wildly. Then, if the mitigating factor solves that problem, then your value of liabilities isn't necessary.

MR. EDWARD W. LEPPERT: I guess our discussion centered on the problem with the methodology of *FAS 97* and incorporating *FAS 115* to it. Because it was our understanding that *FAS 97* was designed to take the stream of profits. When you take these capital gains at the beginning and you have this very low or insignificant margin going out in the future, basically you end up with many future losses in your amortization stream.

Well, that gives you two problems. One problem occurs if you look at the recoverability of it. The second problem is, at least in the software that I personally have dealt with, it sets these profits to zero. So our auditors made my company adjust the software so that we showed these huge negative losses. Was *FAS 97* really designed for this? I think the ruling on *FAS 97* was that if you had significant losses in the future, you might use the revenue method. So are we using a proper tool to handle this?

The second point that I would have in that is the assumption consistency. If you were to realistically get all these capital gains and then have zero spreads or unprofitable business, a company's lapse rates would probably go up because they probably wouldn't even service these people anymore. They want to get them off the books. So, I don't know if that's necessarily true, but you're maintaining all your other assumptions except you're modifying your interest. Well, that doesn't necessarily play out, you know. It's an inconsistency.

The other problem that my company came up with is that sometimes we obtained negative factors. So if we had a negative factor when the factor method that we had, then that goes directly, I think, into the question. That would probably mean, OK, you write your DAC down to zero, but then maybe you should increase your liability, which we can't do, so then we're not being fair. You can't change one side and not the other.

The fourth point that I want to make concerns the methodology that we set up, and this was, again, a software constraint. We used a mean reserve method on the one side with the high capital gains. We had a real high DAC factor and then an extremely low DAC factor, and we took the mean. We felt, to be correct in using this method, that first factors should ignore that higher one, but our auditors told us to be consistent with the methodology that we were using before. You know, it is a new area, so we don't know if we're handling it 100% correctly. We're doing the best we can. And so the big problem I see is, I don't think *FAS 97* was designed to handle *FAS 115*.

MR. ROBBINS: Let me just respond to that very briefly. I'm going to quote an article that Dick Robertson wrote a few months ago in one of our actuarial magazines. He

said something like, bad accounting rules should not influence investment strategies or the sophisticated investor with respect to affecting the price of the company stock itself. Bad accounting should not influence their opinions of the company. He went on to say that not all investors or users are sophisticated, so we still have problems.

But let's take your concept of policyholders who want to leave the company because you're crediting lower crediting rates in order not to have balance sheet problems because of *FAS 115*. I think those concepts are somewhat connected. In other words, if your investors or users are sophisticated enough not to care about the aberrations that *FAS 115* is causing for the moment, maybe it's not as much of a problem as one might think. It's really hard to say. The jury is out.

The Fox Pitt Kelton article that I read would indicate that, yes, there are some analysts out there who are putting a great deal of credence in your book value as a result of *FAS 115*. So you may be right. It's hard to say.

MR. KOLSRUD: Other comments on question number three before we move on?

FROM THE FLOOR: You touched on total return. If part of your assets are invested in, say, common stock that are available for sale and mark to market, and you credit interest based on the unrealized capital gains on those common stocks, following the logic of *FAS 115*, can part of the reserving fee be passed directly to equity and not go through income?

MR. HOHMANN: I think that is a case to be resolved in audit, but in theory that is where the point is headed. The idea is that if you actually do have total return crediting strategies that are well documented, then you would establish a liability to the extent that you would expect to ultimately credit those gains through to policyholders.

I think the jury is out as to how auditors will react to that. But the point was to let you know what the current discussion is. It will be resolved as people attempt to implement; it is unresolved today.

MR. PAUL A. NEALON: When you're doing your DAC, and when you're using your profit stream as your amortization schedule as required under *FAS 115*, what if all of a sudden you have negative profits in the future? Can you use a different amortization schedule? Can you change to gross revenues?

MR. ROBBINS: Well, that was going to be a part of my presentation if we didn't have the time constraints. If you have a situation like that where your profits are going to be negative in the future, the constraints on that secondary DAC is really the question. And if negative gross profits occur in any year, you know, that under *FAS 97* you must go to that alternative amortization basis.

There are schools of thought here that the SEC did not grapple with. It wanted that secondary DAC, but it didn't go into one. That was one of the issues, and it's still an unresolved issue.

My own feeling is that you either ought to ignore those types of constraints and stay on that subject of loss recognition issues because you can't defer future losses, or use constraints at the point that the primary DAC is incurring them to have some sort of a consistency of the amortization schedules, if the negatives are not significant. If the negatives are substantially significant, then it's a tough question. You know, it's a question of symmetry and whether the valuation allowance becomes a logical number. That jury is out.

MR. KOLSRUD: Shall we go back to question number two on *FAS 107?*

MR. MICHAEL LADD BEESON: We discussed methodologies used to provide for disclosure of fair value liabilities under *FAS 107. FAS 107* deals with investment contracts. We identified the format as we wrote the following down: cash surrender value, account value, discounted cash flows, and appraisal-value techniques. The first two of those are fairly objective. The cash surrender value and the account value are much easier to compute, which gives them some benefit of using those.

The problems with the cash surrender value method, although it would be right in one case if the policyholder does surrender immediately is it doesn't really recognize any of the options that the policyholder has to maintain the contract and get a higher value later on.

The account value method perhaps does a better job of measuring the policyholders equity in the contract, but it doesn't really recognize the time value of money because they don't necessarily have the option to surrender for the account value now.

That moves us on to the other methods. Discounted cash flows and appraisal value techniques, both involve projections, actuarial assumptions and multiple scenarios. I think as analytical actuaries, we were more comfortable with the idea of appraisal value techniques to come up with the best fair value, but we also recognize that that's going to be more complicated and more expensive to do. We've identified some problems.

MR. BARRY L. SHEMIN: I don't think we filled in too many holes. We basically went over the four methods that had been listed on the slide, and concluded that cash value, account value, and discounted cash flow, were all methods that we were aware were in use. Discounted cash flows are primarily for GICs. We were not aware of much use of appraisal techniques, and we were not aware of disclosure of universal life liabilities under *FAS 107.*

In fact, what struck us about this question was how much of a nonissue *FAS 107* had been. There's much disclosure of market values, but nobody's really making much of it. Maybe that's because it's in a footnote, but perhaps it's also because interest rates have been going down for most of the time while this has been in effect. We wondered whether people might start paying more attention to *FAS 107* as interest rates go up.

MR. KOLSRUD: Any other comments on *FAS 107?*

MR. ROBERT J. LALONDE: I was just wondering what happens when you buy a company? Don't you sort of go through a situation where you assess the market value of assets and liabilities and make assumptions about the investment using future profits? What do you do in that situation going forward once you buy the business?

MR. KOLSRUD: Are you talking about *FAS 107* or *FAS 115*?

MR. LALONDE: *FAS 107.*

MR. KOLSRUD: We actually are probably one of the few companies that use the appraisal method technique for *FAS 107.* And, as you said, we have bought a few companies and blocks of business over the last couple of years. There's a direct relationship between what you pay for the block, or the company, and what we carry for the fair value of liabilities in our disclosure statements. There's some differences in assumptions but the methodology is consistent. But I think we're in the minority. Most companies are not using an appraisal method in their disclosures.

MR. LALONDE: Do you use the same assumptions under which you purchased the company?

MR. KOLSRUD: In general, we use the same assumptions. We may use a different discount rate which would change the value. We may include different margins. So it may not be a one-for-one translation. But basically the assumptions are, if not identical, similar.

Our final question concerns putting fair values on liabilities.

MR. R. THOMAS HERGET: We discussed these issues and we quickly agreed that we couldn't agree on any answers, but we could agree on what the questions could be. We contemplated what impact, if any, the existence of statutory accounting should have on a value we would come up with. What's the impact of cash values, book value, cash values? We talked about the nature of the guidance in determining fair-value liabilities? Would it be a cookbook where we could look up what to do for a discount rate? How to select something. What to do for expenses. Or would it be a series of fundamentals and principles in which we could read into a little bit more and perhaps come up with different values. Say two actuaries could come up with different perspectives, different values. So how would this roll out? We thought that would be an important issue.

We also thought that we have to keep our eyes on political items. Might whatever we come up with for market value of liabilities impact how our taxes might be paid? We really went round and round on what is value? What would a person pay for liabilities? And, as we know, consultants can come up with different appraisals. And if I'm the owner of a company, I would believe this was worth something. You could have different people wanting to buy it and they would see different elements of value in it as well.

So we really concluded that one approach that would work would be can we get our hands on fair value of assets. And if I'm the owner of a company and I know what I would sell for, and perhaps I know what a consultant would appraise it for, I can get

a feel for what the surplus would be. So the balancing item would be the fair value of liabilities.

MR. HOHMANN: I scribbled down the things that you said, Tom, and I guess the first thing is statutory reserves. I do think there is a place for statutory reserves and fair valuation of liabilities because I view them as a capital consideration. For example, if you had explicit appraisal techniques, they would in fact take into account statutory reserves.

If you used option-pricing techniques, it seems to me that one way to, at least, implicitly address statutory reserves is through the option-adjusted spread.

Cash surrender value is an interesting point. I think that really goes to the question of market efficiency, and I think it ties into a separate point that you mentioned about the political question of taxes. Presumably, if you were to allow the cash surrender value flow to be broken in a fair valuation of liabilities, you'd have the question of, what does that mean with respect to tax reserves? It seems to me that is not a new question. I believe that it routinely occurs that net GAAP liabilities fall below cash surrender values, and thus far, to my knowledge, that has not caused tax reserves to follow. Therefore, I think that there is precedent to ignore the piercing of a cash surrender value by a GAAP reporting item when computing tax reserves.

Another point about cookbook versus fundamental principles. I am certain, based upon what I've seen in the past with respect to appointed actuary considerations, that cookbooks would not be developed. It just doesn't seem to me it's the way that our profession goes about things. Instead, we realize that we're all highly qualified professionals and can apply judgment within guidelines appropriately.

You made the point about policing assumptions. While the issue is difficult, it is not entirely new. It seems to me that auditors have had to struggle with that issue already under *FAS 97*. So I think that's not necessarily new ground, but it is an important consideration.

And then there's the question of what people might actually pay for the liabilities. If we knew that, we'd have the answer ahead of time. I think that's why it's called fair value instead of market value.

MR. KOLSRUD: Our last group, please.

MR. MARTIN E. GOLDMAN: As far as a cash value floor, we decided that it would depend on the characteristics of the business. You would take into account an appraisal value. If you had a very stable block, you could go below the cash value of the block, but you shouldn't.

For cash-flow testing, I guess there was this question of whether you could disconnect the assets and liabilities. And we were thinking that would depend more on the efficiency of the insurance market. If you can get your spread no matter what, then you don't have to disconnect. You shouldn't disconnect, for instance, on new money rates and a very efficient segment of the market.

When we were discussing discounting cash flows and I suggested we might discount at a treasury rate, everybody jumped on me and said, no, you would have to increase it for a spread. Bring it up to your earned rate, or something like that. I guess it's a question of whether there should be an allowance for any future profit margin. For instance, on your asset side, when you put on a new block of business and you book a market at the same, it's OK because you just bought the assets/liability side. Should market value reflect all the future profits as you would in a gross premium valuation? Or should it be the same? When you put the business on, should it be the same?

MR. HOHMANN: With respect to the incidence of profit, even though assets are purchased at market, they provide returns over their lives. The same should happen with liabilities. Market-value accounting does not mean fronting all profit.

MR. KOLSRUD: On the appraisal method, it certainly can become a very significant issue if you're using a discount rate or risk rate of return different than the internal pricing rate. The way I look at it, if you use the internal pricing rate, the internal rate of return in the calculation of the appraisal value and the fair value of liabilities, there will be no gain or loss at issue. But if you use anything different than that, it will be different.