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FAS 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
 - Testing of experience against assumptions
 - Changes in future assumptions – short term versus long term
 - Treatment of capital gains and loss – interest related versus credit related
- Examples
 - Single premium deferred annuity (SPDA)
 - Universal Life (UL)

MR. ERIC R. SCHUERING: Errol Cramer is with Allstate Life in Northbrook, Illinois, where he serves as the company's appointed actuary and has responsibility for GAAP and statutory valuations. Howard Rosen is vice president of financial reporting of the CONSECO Companies in Carmel, Indiana. He is responsible for statutory and GAAP accounting for the CONSECO Companies and CONSECO Capital Partners.

Before we get started, I'll comment on FAS 97 from the perspective of an actuary in public accounting. I see quite a few different approaches to FAS 97 in the various audits that I work on. Probably the most noticeable thing about FAS 97 methodology and practice is that there's quite a wide variety of practical approaches that actuaries take. I don't think any two companies interpret FAS 97 exactly the same way, even though everybody is trying theoretically to get to the same basic type of output. I think this derives primarily from the fact that most companies have home-grown models for FAS 97, as there are nearly as many of standard models or software packages that people use.

FAS 97 departs from FAS 60 in the practice of allowing regular unlocking of assumptions and restatement of unamortized acquisition costs instead of the lock-in approach that holds under FAS 60. How and when this unlocking is done provides most of the serious issues that we encounter in auditing other actuaries' work on FAS 97. I'd say that most actuaries probably unlock and recalculate their FAS 97 deferred acquisition cost balances once a year, but there's a lot of variety, especially among smaller companies and among smaller blocks of business in larger companies.

When unlocking is done, it frequently is partial. Sometimes people will only unlock for one assumption on a regular basis (for example, the interest spread) and then provide for unlocking on mortality at less frequent intervals of time, like every two to three years. Very frequently, when we see how the unlocking is done, the documentation is rather sketchy or involves a lot of actuarial judgment. Errol Cramer will talk about

Allstate's unlocking process, and he'll give a much more detailed look at how he handles this area of FAS 97.

There are also a number of other special issues that crop up in FAS 97 accounting. One of these is recoverability. The regular unlocking of assumptions can give some comfort that recoverability is being addressed regularly. But depending on the way the model has been constructed and the realism of the assumptions, sometimes a separate look via another model is warranted. Very frequently, this can be done with some of the output of the cash-flow testing.

Another special issue on FAS 97 is purchase accounting. This is an area of few standards, even for FAS 60 products, and FAS 97 is no different. The Emerging Issues Task Force (EITF) of the FASB has recently issued a consensus ruling (Issue #92-9), on purchase accounting, however, which gives a little bit more guidance in this area. Howard will talk about how CONSECO has handled the EITF ruling.

The other piece of authoritative accounting literature on FAS 97, which is the AICPA's Practice Bulletin No. 8, indicates, among other things, that capital gains and losses should be run through the estimated gross profits in determining the amortization of deferred acquisition cost (DAC) under FAS 97. My impression is that many actuaries still aren't doing this.

Because we've had falling interest rates in recent years, many companies have taken capital gains on their investments. Running capital gains through the FAS 97 models normally will speed up amortization, and accountants have been concerned when companies don't provide for higher DAC amortization during periods when they are recognizing high volumes of capital gains. I don't know if they would be nearly as concerned about capital losses and the fact that you're allowed to run the losses through the FAS 97 models. That would tend to do the reverse to amortization. I believe both Errol and Howard are going to touch a little bit upon the issue of capital gains in their discussions.

MR. ERROL CRAMER: Eric asked me to talk about Allstate Life's deferred acquisition cost unlocking process under FAS 97. But I'd first like to cover the implementation of FAS 97 at Allstate Life.

We introduced FAS 97 at year-end 1988, and our management had very specific requirements. These were the requirements when we introduced or implemented FAS 97. Management wanted to make sure there were no spurious fluctuations. It didn't want the valuation actuary to dictate results. I think you're all familiar with the valuation actuary saying, "Give me the results you want, and I will solve for the assumptions." They're tuned into this.

The second requirement is that it all be explainable. Allstate is owned by Sears. It's a large corporation and things have to get explained all the way to the outside world. There's almost a paranoia about random fluctuations or something that doesn't have a very good explanation, especially if it might send the wrong message to the public. The third requirement, and I'm sure this is consistent with many companies, is that there be no major expense. They wanted it done inexpensively, and I don't think that is necessarily bad.

FAS 97

We were putting in a new policy administration system in 1988, and that involved many expenses. The last thing management wanted was -- on top of administrative expenses and what it thought was an increasing trend of expenses -- to create a whole new system or methodology for handling FAS 97. It wanted that kept in perspective. After all, it's just a financial entry on a balance sheet. You're going to amortize DAC over so many years and it wasn't overly concerned. Again, this was the mind-set when we implemented in 1988. Of course, things do evolve and change.

We also had extensive discussions with our auditors. I'm sure most of you, when you implemented FAS 97, went through the same series of discussions and negotiations. We were getting a feel for how we were going to do all this work. There are really three themes that seem to have come out. The first one is nonmanipulation and I guess that's obvious and taken at face value. The second theme is consistency. Now, Allstate Life is really an amalgamation of seven or so insurance companies split among different business units. Allstate wanted to ensure that there was consistency within the company, as well as consistency from year to year. The third theme is that it be readily auditable.

When we implemented in 1988, we did so in much of a rush. The big thing for us in 1988 was actually FAS 96, the deferred tax change. For Sears, our parent, that was a major, major item and FAS 97 was tacked on at the back end. So we did something very crude, and we came to the understanding that we would, going forward, do something more sophisticated.

Looking at some of the practical requirements from the valuation actuaries, the important thing is that it gets integrated with our other work flow. I'm sure many of you who do financial work know there just seems to be more things to do and not enough time or resources. Because of a lot of opposition or friction from the valuation actuaries, we just added another layer of work. At Allstate, the valuation actuary wants the annual statements done in the first quarter. You get to see your family in the second quarter. We have some breathing room and we can do a DAC recoverability study in the third quarter. Before we know it, it's the fourth quarter, and we're already doing year-end planning. We do our cash-flow testing, as a matter of interest, near the end of the year and so that keeps us busy.

Again, at the time of implementation the thinking, was that if we really wanted to do a good job on the DAC unlocking, we could really only handle it once a year. It would have to be in the third quarter to have any of the unlocking results flow through the financial plans, which were done late in the fourth quarter. One of the requirements from our auditors was that we have a formal unlocking policy statement. Actually, it was a mutual requirement, as I felt it necessary to have it for my discussions with management. We settled on the following points.

I guess the first point is that, as I mentioned, we would do at least an annual study based on our midyear results. The second point is that we would unlock anytime there was an unusual event. This led to a lot of discussion as to how we would define an unusual event. I've been on committees in which we have tried to define terms like *materiality*. This ranks right up there with them. As it turned out though,

it hasn't been contentious. It's obvious when you do have an unusual event. We haven't had to discuss it with auditors.

In any case, we come to the third point, and that is we would not change our future assumptions unless we could justify doing so. In fact, we also have to justify not doing so. The reason is getting back to the no-manipulation requirement. It's just too easy to change the DAC amortization by playing around with assumptions. There is a bit of backsliding that happens; we have to be vigilant with our business units. In any case, we made a very strong point that unless we could justify it through experience studies, we would not play around with assumptions.

The fourth point was that the only way the process could be auditable would be if we projected actual dollars of gross profits. Now, the initial implementation was done with a hodgepodge of systems and a little bit was on a model basis, male 35, non-smoker, whatever. We realized that the only way we would have something that would be auditable would be if we actually projected dollar amounts for the total in force that we or the auditors could relate to the actual financial statements.

There is a final point and that's disclosure. I don't know if this is an issue for all companies, but we reached an agreement that we would only disclose when there was a significant or material impact on the organization. This is at the level at which the GAAP reporting was done. Obviously, for Sears, nothing is material unless you're the U.S. government. But when getting down to an Allstate Life level, we would have to look at materiality for Allstate Life alone. As it's turned out, we have actually unlocked our DAC by some amount each year. I think it's difficult to justify not doing so. We haven't had to address the materiality, and so we haven't had any disclosure of any major unlocking to date.

We have seven major business units. Three of them have essentially little or no FAS 97 DAC, so we can really break our business down into four major business units that we need to concern ourselves with. Two of our business units bought a vendor system. For those of you who are curious, it's PolySystems' Horizon System. The other two business units had developed their own in-house systems.

Let's look at very conceptual terms. What underlies the vendor system? I guess a key thing is that it works off the policy master record, so it's mainframe based and it manipulates the data. We're talking about real, live data, all the policy records in force, and all the policy accounting data, which are downloaded into a personal computer (PC) for projection purposes. It's highly mechanized once you have it up and running.

On the asset side, though, it's relatively, but not entirely simplistic. It does work off crude assumptions, such as projected interest rates. I see such a system best suited for a portfolio product like universal life. You don't need to necessarily capture your investment margins or experience down to the issue-year cell of your valuation. Things get spread out on the asset side versus the more detailed approach used on the liability side. As it turned out, the business units that used the system happened to also have significant universal life and related life insurance blocks.

We really had two in-house systems. Generally they followed the same pattern. They required manual effort. We are trying to streamline the process, but it is a tedious and time-consuming job to do the DAC unlocking. It requires a lot of manual input, and that's one of the disadvantages, I guess, if you do something internally. The interesting thing is that it keys off the actual asset database, and this brings up a point that I made before. If you have heavily investment-related products, you probably want to get down to investment experience at the valuation cell level. Again, this theme will come out later. I have some practical examples that will illustrate the importance of this.

For the liabilities, the in-house system is simplistic compared to the vendor system, but one can make it as complex as one wishes. We have 6,820-plus cell-projection systems. But unless you get almost down to a serialtim level, it gets very difficult to capture all the operations of a universal life product. Trying to project future surrender charges, for example, is very difficult when you use aggregate-type projection systems. Again, it's best suited for the interest-year-method-type products; for example, in single premium deferred annuities in which your credited rate depends on when you receive the money.

To illustrate the conceptual difference, we're going to take a look at asset defaults. Now, seemingly this is simplistic and not very difficult to understand if you have an interest-year-method-type product. You'll have your assets allocated to the particular periods in which you receive the premium. If you get a default, you know which asset defaulted, and that default then belongs to a particular valuation cell. If you have a portfolio product, you are probably segmented or, if not segmented, you'll take an average return for the portfolio and you'll split it among all the issue years within that product.

Table 1 is a hypothetical example, but it's actually not too far off from a five-year CD annuity. It illustrates the point. In this case, we're looking at a policy that's in duration 2 and the original expectation is that one has \$100 of gross profits each year for five years. Our initial DAC is \$10. I've ignored interest, but there's no loss of accuracy. The results are still valid.

TABLE 1
Policy-Year-2 Illustrative Example

Year End	Original		Revised	
	Gross Profit	DAC	Gross Profit	DAC
1	100	8.0	100	7.5
2	100	6.0	40	6.5
3	100	4.0	60	5.0
4	100	2.0	100	2.5
5	100	0	100	0
Total	500		400	

Change in DAC = 6.5 - 6.0 = 0.5.

RECORD, VOLUME 19

Due to asset defaults in year 2, we have 40 instead of 100 second-year gross profits. That's our asset default being reflected. We also anticipate that we're likely to suffer a level of defaults for at least one more year, so there's some sort of trailing-off effect that hits year 3. Our DAC pattern is now 10, 7.5, 5, 2.5, zero. If we look at policy year 2, we're somewhere between 7.5 and 5, and we end up with 6.5. What's happened is we've had a hit from an asset loss. It hit us in year 2 and our DAC is now 6.5 versus the 6 that we had originally held, so we would write DAC up under this example at about 0.5.

We now go to a similar example (see Table 2). This is another policy, but it's in year 4. It has the same asset default hit, 40 instead of 100 in year 4, followed by 60 the following year. So, it is an identical sort of asset default, but it has now hit the policy in year 4. We go through the same process and we come up with a revised or unlocked DAC. That's 1.5 versus a DAC of 2.0 originally. In this situation, we're going to write down DAC by 0.5. Even though we had the same asset defaults, if that asset default hits a policy in year 2, it's a write-up of DAC, because DAC is acting as sort of a counterbalance. You have less gross profits and so you amortize this now. If the policy is in a later duration and you get hit, you find you have the opposite effect. You have a write down of DAC because you have less gross profits in total.

TABLE 2
Policy-Year-4 Illustrative Example

Year End	Original		Revised	
	Gross Profit	DAC	Gross Profit	DAC
1	100	8.0	100	7.5
2	100	6.0	100	5.0
3	100	4.0	100	2.5
4	100	2.0	40	1.5
5	100	0	60	0
Total	500		400	

Change in DAC = 1.5 - 2.0 = 0.5.

This is the phenomenon that we experienced when we had high-yield bond losses a few years ago. I guess you would see it the same if it were mortgages or whatever. We had two products (see Table 3). Product A and Product B are very similar products, except in one case, we had an interest-year crediting strategy. Under Product B, we credited an average portfolio rate. When we allocated our high-yield default losses, these tended to be defaulted assets that we had purchased at least a few years prior.

When we came to Product A (the interest-year-method product), the older assets were allocated to the older deposit monies for later durations, and we saw a write down in the DAC. When we looked at Product B, which was a very similar product but sold in a different profit center, its cells had increased so that the business was more heavily weighted to the later durations. Even though these asset defaults had

occurred from older assets, the results were split among the portfolio yield as a constant sort of deduction and they had a write up.

TABLE 3
Actual Deferred Annuity Examples

Products	Credited Rates	Allocation of High-Yield Defaults	DAC Unlocking Impact
A	Vary by issue periods	To older issue years	Write down
B	Portfolio rate	To overall portfolio	Write up

As I said, management wanted explainable results. When we had suffered extensive high-yield bond losses, we said there was no DAC unlocking, but we had to go through some of this exercise because we got these squinty-eyed looks from management saying "Yes, yes, yes, valuation actuaries. There will never be a DAC unlocking." This isn't a contrived example. This is an actual situation that we experienced at Allstate, so I guess the point is that one really has to take a deeper cut beyond just crunching out the numbers.

We first do marginal analysis to analyze our data. Many companies talk about separating the impact of taking the actual gross profit results and separately identifying them, future changes in assumptions, etc. We found it's really difficult to unbundle the pieces, but we like to go through the unlocking process in marginal steps. Again, these are not actual numbers in Table 4. I used actual numbers and then just ratioed them, so these are realistic on the scale.

TABLE 4
Marginal Analysis

Original DAC balance	180
Updated gross profits and inforce	3
Model enhancement	(1)
Revised persistency assumption	(8)
New cost of insurance (COI) table	3
Other	1
Revised DAC balance	178

In this case, we had a product that really had a marginal amount of DAC unlocking. The original DAC was 180 and the revised DAC was 178. On the surface, it appeared that not much had happened. Again, if you go and look into the different pieces, by putting in actual gross profits and updating the in-force, we had written DAC up by three. There's always going to be model enhancement, adding riders, or fiddling around with improving the model, and that can add a bit of noise to the results. In this case, we had a persistency assumption change. We saw that we had a need to increase our credited interest rates because of the poor persistency. You throw it all together and there's not much impact in the DAC unlocking, but there are significant underlying durations that one wants to look at and verify if these are credible.

RECORD, VOLUME 19

The second thing we do to analyze the data is a reconciliation with the financials. I've taken a simple example (Table 5) and, again, fairly realistic numbers. We start off with \$75 million of actual investment income for the reporting period, and this \$75 million relates to \$900 million of segmented assets. Now, there's no reason why one should segment assets based on fund balances. But in terms of the gross-profit methodology, the assumption is that you invest assets equal to your fund balance or GAAP reserves. We had \$75 million of actual P&L investment income, and we needed to ratio that up to what we would have earned had we had our full \$1.1 billion of fund balance to invest. We take the \$75 million and we ratio that up to \$92 million.

TABLE 5
Reconciliation with the Financials

a. Investment income	\$ 75 million
b. Average invested assets	900
c. Average fund balances	1,100
d. Grossed up investment income (A ÷ c/b)	92
e. Modeled investment income	90
f. Ratio (d/e)	101.9%

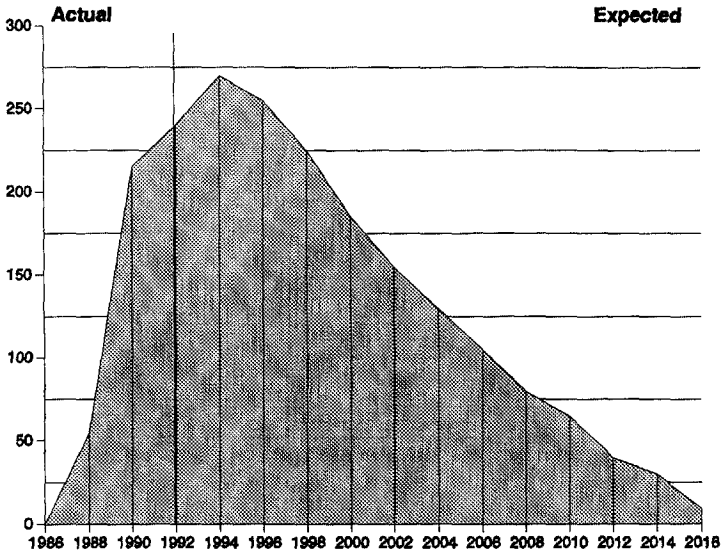
Typically, one would input various assumptions into a model. Again, we're talking of actual, but you have to allocate actual results going back to your models, based on assumption of certain fund balances and distribution by issue year, etc. When that all pops out of the model, it says that you told the model that the actual results were \$90 million. Well, they weren't quite \$90 million. You would have expected \$92 million. You can either decide that's not material, that it's close enough, or you could just decide to ratio up results 92 over 90. But there's always a danger if you just rely purely on inputs into a model, no matter how sophisticated the model. You still need to make sure it reconciles with actual financials. This is true for investment income. Another obvious thing you want to do is make sure your deferrable expenses tie back. That's always not obvious from a model, especially if you have renewal deferrable expenses.

I guess Eric had mentioned capital gains. Our understanding is that capital gains and, in our case, capital losses, should get reflected. They are truly part of the gross profits, as long as they belong to the assets that we have segmented and that we are actually holding in respect to those products. I guess just purely as a technical point, we would not ratio up or down our capital gains or losses as we have in this example, because our assets are different than our fund balances. Capital gains or losses are the dollar amounts that actually resulted. Given that FAS 97 now treats capital gains and losses as part of operating income, we believe that they properly belong in gross profits and should not be excluded.

There is a final bit of analysis that we do to verify, and I call this the eyeball test. Here we have a block of business (see Chart 1) and to the left of that solid line are the actual gross profit results. Then you see the projected future gross profit results. This shows a block of business with many issue years combined, no new sales, and that's why it trails off. We actually look at these results by issue year.

I think it's more instructive. In any case, by just looking at this pattern alone, one would be a bit suspicious of the sort of discontinuity from actual to expected.

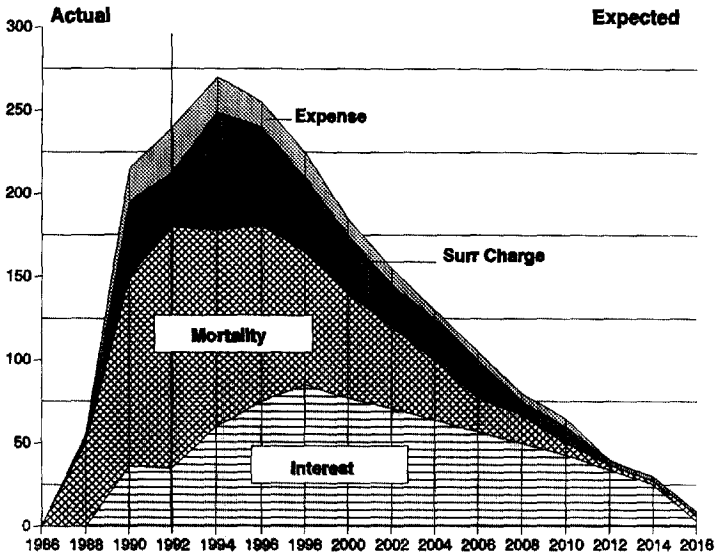
CHART 1
Gross Profits



Again, you would see this more readily if you just looked at one issue year alone. I've just summarized the results here for presentation. This would give one pause to maybe go back and say, "Are we being a bit too optimistic about our future gross profits?" Chart 2 shows the different layers that make it up, different underlying margins. I guess it's just interesting to see the relative distribution of the margins, but one may also uncover, if there's one particular margin of concern, something that you may need to take a better look at.

Again, I'll get back to surrender charges. I've found that of all the troublesome things to try to predict or project, surrender charges for universal life products are very much up there. Again, one gets a bit of this if you look at it by issue year. Certainly, the eyeball test is a very basic thing you can do, and it's probably one of the best ways to validate your model.

Finally, I'd like to talk about some of the miscellaneous issues that we've had to address. The first has to do with internal replacements. The second issue has to do with recoverability or writing off of DAC. The third issue has to do with asset portfolio restructuring. For internal replacements, we've established the following with our auditors, and I think this is generally common. If you want to roll over your DAC to a new product, there are really two requirements.

CHART 2
Gross Profits

The first requirement is that your replacement product must be similar to your original. It wouldn't be valid, for example, if you had a universal life product rolling over into an SPDA or if you had a term universal life rolling over to a high-level, premium universal life. The idea is that the replacement should be more of an update of an existing policy than replacing to a new type of product. The second requirement is that the deferrable expenses be less for the new product than a new issue. Otherwise, there's no reason to treat this as anything different but a new issue. We regard this as being a fair interpretation and, for what it's worth, this is what we follow in terms of internal replacements.

I have a few items on DAC recoverability that you might find of interest. The first item has to do with a distinction between investment-only products and universal life products. For investment-only products, you would write DAC down to the level at which it was recoverable; if need be, write it down to zero. But one is not required, or I don't even think one is permitted to increase the level of reserves because of future losses. Apparently, this is the way that banks would treat similar types of products. In other words, to the extent you had any deferrable expenses, you would write those off. To the extent you have future losses, you would not reserve for them. You would just suffer them as they occur.

A second item was an actual issue that we faced. Fortunately, it was a small block that wasn't material, so it was more of a theoretical issue. We had a small block that had severely impaired assets – mortgages in this case – and based on the assets in force, the projected cash flows would have been insufficient to amortize the DAC. We wrote off the DAC on this block, but we also knew at the time we were writing down DAC that we were likely to swap out some of these assets and write them

down for book-value purposes. Once we had written down our assets or moved to new assets, we knew the block would be recoverable.

The issue there was whether to write DAC down. It's not recoverable. Do we write it down and then write it up again when we change the assets or write down the book value? This really was unresolved. It was an insignificant block for us, so we decided to write it off. We did not reinstate the DAC. If you are doing a recoverability study, you probably want to know if any future actions are going to change the analysis.

The third and final issue is asset portfolio restructurings. I think the impact is straightforward once you change your pattern of gross profits. Typically, you either have a capital gain or loss and that would be followed by either increased or reduced investment income, depending on what you're doing with your assets, so you will be changing the pattern of gross profits.

Asset portfolio restructurings can occur when you transfer assets internally; specifically, transfer assets from FAS 97 to non-FAS-97 products. You can significantly change your pattern of gross profits without the overall company results being any different. It just opens up to game playing. In our case, we had a valid business reason for our asset restructuring, so the auditors weren't concerned. I think that's the bottom line. If you repositioned your assets purely to change the gross profit pattern and play around with the DAC schedule, a vigilant auditor would pick that up. But if you have a good business reason, even though the company's assets have not changed, you do get a change in DAC. That's just the way that FAS 97 works.

Just to conclude, at Allstate we've really seen the FAS 97 process as two phases. The first phase was building the models and getting the accounting mechanism in place. I think we've gone through that first phase. The second phase is getting to the stage where we felt comfortable with the results. We could analyze the results and explain them. We're at that stage now. There are countless issues, and I covered three for example purposes, but there are many other issues.

I think we and our auditors now have a good understanding of what we're doing. There really is a third phase that's not shown and that gets back to what I said about management wanting something done inexpensively. It felt this was just a financial item and didn't really drive anything. Well, it now realizes that this is important and it would like it monthly or quarterly. Even though DAC is just a financial item, a large amount of DAC is amortized in every period's financial statement. The rate at which you amortize DAC hits your income directly, and stock analysts are looking at price/earnings (P/E) ratios. Those income changes get magnified in P/E ratios, so management has become much more attuned to the fact that the amortization pattern of DAC is actually very important.

In any case, there is a third phase, and that's going back and doing systematic monthly or quarterly unlocking.

MR. HOWARD L. ROSEN: I'm the appointed actuary and vice president of financial reporting for CONSECO in Carmel, Indiana. As many of you know, CONSECO has grown very rapidly during the past several years. We've gotten a lot of notoriety,

RECORD, VOLUME 19

some deserved and some not so deserved, because we've gone through many acquisitions. In fact, during the last three years, we have acquired four reasonably sized insurance companies, the last one being Bankers Life & Casualty in the latter part of last year.

Our primary product line, with the exception of Bankers Life & Casualty, is deferred annuities sold primarily through financial institutions. You can see that we are greatly affected by FAS 97. I would like to briefly discuss some of the issues affecting CONSECO and companies like CONSECO.

These issues generally affect all lines of business, not just FAS 97 products, but I will try to concentrate on the issues as they affect CONSECO. Just to give you a little flavor of what CONSECO looks like, Table 6 shows our GAAP liabilities, with the exception of Bankers Life & Casualty, as of March 31, 1993. Bankers Life & Casualty is about a \$2 billion company primarily in A&H products, so it would primarily be a FAS-60-type company. As you can see, the CONSECO Company (CNC), companies wholly owned by CONSECO, and the CONSECO Capital Partners Company (CCP), with the exception of Bankers, are primarily investment contract and universal-life-type contract companies. About 85-90% of its liabilities are covered by FAS 97 products.

TABLE 6
CCP and CNC Insurance, Inc. Insurance Liabilities
March 31, 1993

	Net of Reinsurance Ceded (\$ Million)		
	CCP	CNC	Total
Future Policy Benefits:			
Investment 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
Total Insurance Liabilities	4,182.2	7,426.2	11,608.4

The two issues that I'd like to discuss are the Emerging Issues Task Force position on purchase accounting and the treatment of realized and unrealized capital gains. We'll probably just have time to go over realized gains in the deferred acquisition cost and present value of profits amortization process.

It's been common practice, as all of us know, for insurance companies to buy other insurance companies, as we at CONSECO have done during the past ten years, and to establish on the GAAP balance sheet an asset for the present value of future profits (PVP), which is the value of the inventory of the policies in force on the date of acquisition. This asset is frequently calculated by projecting the future profit stream

and discounting that profit stream at a risk rate of return, such as 17%, 18%, or 19%.

I say *frequently* because it should be understood that there is no one correct, accepted way to apply purchase-accounting principles. Some companies project profits based on a profit margin that would have been effective as of the date of issue of the products and discount that profit stream at a liability or asset rate. Other companies take the projected profit stream as of the date of acquisition and discount that stream at a risk rate of return. We have historically used the latter approach; that is, we use a risk rate of return or what I refer to as the traditional approach. Also, I might add that there is a common, although not universally accepted, test for recoverability of the PVP asset. This test uses the present value of profits at the original interest rate (say 18%), or at a lower rate if the present value of profits at the original interest rate is insufficient to cover the remaining PVP asset. Some companies will reduce this discount rate that is used to value the remaining profits all the way to 0%. The PVP asset is still considered recoverable under the theory that the inventories and assets acquired are still earning assets. But, the asset that was thought at purchase to be earning 18% is now earning, for example, 14%. At that point, we'll change our discount rate and future amortization pattern to a 14% interest basis. I mention that now because it will be important when I get to the conclusions of the EITF.

Last year, the SEC took a closer look at purchase accounting for insurance companies and it seems to have taken exception with what I have termed the traditional approach of using a risk rate of return to accrete interest on the PVP asset and to amortize that asset. It raised several issues and sent those issues down to the EITF of the FASB. Last year, the EITF did its research and held hearings attended by consultants and insurance company employees as well.

The issues raised by the EITF were as follows. First, is it indeed appropriate to accrete interest on the PVP asset at all? Should it be an interest-bearing asset? Second, if the industry or the EITF and the FASB agree that interest should be accreted, what level of interest rate can you accrete? Third, what do you do to your PVP asset if there is a change in estimate of future experience?

Again, another what I will call traditional or prevailing practice in the industry is that if you acquire a company and you set up your PVP assets for the various blocks of business in which you have acquired FAS 97 blocks, estimated gross-profit concepts and DAC or PVP unlocking concepts don't really apply. If you then have a change in estimate, what should you do? Should you unlock? Should you not unlock?

Finally, how do you handle recoverability? Well, the EITF did its research, had several meetings, and finally came to a conclusion, or a series of conclusions, I should say. First, it came to the conclusion that indeed, it was appropriate to accrete interest on the PVP asset. But it came to the conclusion that, although many companies use the traditional approach of accreting a risk rate of return to that asset, that was not appropriate and the amortization method should be wholly consistent with the method used to amortize deferred acquisition costs.

RECORD, VOLUME 19

It did not, however, deem it necessary to change the way that the PVP asset was initially established on the opening balance sheet, which means that it's okay to establish your initial PVP asset at 18%. But for an FAS 97 product in which you're crediting 6% or 7% when you amortize that asset, you could only accrete 6% or 7%. We'll see how that works in the examples that I am going to show you. The discount rate then, except at the opening balance sheet date, should be the liability rate, and this, the EITF said, should be done for both FAS-60-type products and FAS 97 products. When you accrete interest to your PVP asset, irrespective of what that product is, the interest rate that you are allowed to accrete to the PVP in its amortization stream is the liability rate.

Again, this is wholly consistent with FAS 97 and is perhaps somewhat different than FAS 60. For FAS 97 products, the EITF said that you should make cumulative adjustments in a fashion similar to those adjustments that would be appropriate for DAC. This means that when there's been a material change in actual or expected experience, you should go back and do an unlocking process, reflect corrected or updated past experience for past years, reproject future years, and come up with a new cumulative adjustment to your PVP. This presents a little bit of an interesting exercise and one that we've used in our methodology for treating capital gains.

There is a grandfather date of November 19, 1992. That was the date that the EITF came out with its final position. For acquisitions occurring after November 19, 1992, the amortization methodology should be governed by the conclusions that I just discussed. For acquisitions completed on or before that date, and all of our acquisitions to date have been on or before that date, current methodology could be continued.

The only exception to using current methodology for purchases prior to November 19, 1992 applies to that practice that I mentioned earlier; when examining the PVP asset for recoverability, some companies have used present value of future profits (prior to PVP amortization) as the test for recoverability, with interest rates reduced until the PVP appears recoverable. For all purchase transactions, you may not now reduce that discount rate used to value future profits below the then current liability interest rate. Again, everything that you're currently using can be continued, with the exception of not taking the PVP discount rate down below the then current liability rate in the recoverability test.

Let's take a look at how this EITF method works in practice. Just to show you how this works, we've got a block of business and the profits are declining (see Table 7). The expected gross profit stream appears in the first column. The traditional approach for the amortization of PVP appears in the second column. As you can see, in this case we've discounted our profit stream at 18%, and we get \$83.5 million at date of acquisition.

Now, if this were a post-November 19, 1992 acquisition, we could not use the traditional approach. We would have to develop an approach in which we would only accrete the liability rate to our asset, yet start out at the same point and end up at zero at the same point during the same period of time. How do we do that? Well, if we could only accrete 8% and we were using a method consistent with what we've done historically, we would have PVP that looks like the third column. But we're not going to set up \$134.7 million on our balance sheet.

TABLE 7
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	\$134,706,256	\$13,268,179	\$83,519,004	\$15,033,421	\$14,813,342	(\$220,079)	-1.46%	(\$220,079)
2	20,300,000	77,152,425	124,082,757	12,586,170	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	11,532,155	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	9,729,890	(71,329)	-0.73%	(347,438)
7	12,900,000	50,052,435	80,168,269	7,998,108	49,704,997	9,009,438	8,878,292	(131,146)	-1.46%	(478,585)
8	11,900,000	46,161,873	73,681,731	7,378,099	45,683,289	8,309,137	8,176,564	(132,573)	-1.60%	(611,158)
9	11,000,000	42,571,010	67,676,269	6,820,092	41,959,852	7,662,782	7,536,696	(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	6,397,057	(118,201)	-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%	(1,143,064)
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	4,969,469	(112,727)	-2.22%	(1,378,016)
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	3,906,053	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	29,204,538	3,348,045	18,107,057	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	20,698,747	2,604,035	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	11,256,032	2,352,035	2,344,451	(7,585)	-0.32%	(1,818,416)
23	3,500,000	11,618,899	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	400,592	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

Realistically, nobody would pay that for this block of business. Reasonably speaking, we bought the asset to yield 18%. Under the old accounting, we would have gotten 18% if our assumptions were exactly correct.

How do we get from column 2 to column 5. Well, we'll start out by taking a ratio of two numbers. Those two numbers are the PVP at 18%, \$83.5 million, ratioed to the PVP at 8% at time zero, which is \$134.7 million. We will take that ratio and apply it to our gross profit stream in column 1 and we'll get column 4. That will be what I've termed the adjusted gross profit stream. If you follow the mathematics, you can see that by haircutting the gross profits in that way and accreting just 8%, we will start out at \$83.5 million and we will get to zero at the end of the 30 years.

This is the way that we have interpreted the application of the EITF method. Because a typical company will be accreting less interest, it will write its asset off at a quicker pace. We had one situation with one of our companies in which, if we had used the EITF method for the company as a whole, because of the nature of the products and the speed with which the profits run off, we would have gotten better results had we used the EITF method.

At any rate, the general case is that you're going to have lower profits after amortization by using the EITF method. In this particular case, you can see from column 8 that the income impact is \$220,000 worse by using the EITF method than it would have been by using what I've termed the traditional method. As you can see, at some point in time your profit has got to come back, because you're only amortizing \$83.5 million. Obviously, if you're amortizing more quickly in the early years, you're going to amortize more slowly in the later years. In fact, in this particular instance, that's exactly what happens. The income impact ought to be a zero sum gain. What you lost in your early years, you make up in the later years.

Now, what happens if your income pattern is somewhat different than that? (See Table 8). What happens if your income pattern is level? Well, you have a higher PVP, even at 18%, but still you have a negative income impact that is significantly higher than under the declining situation. In fact, on a relative basis, it's worse as well. It starts out at 4.2% worse and increases to about 7.8% worse, until it ultimately gets dramatically better in later years.

Finally, let's look at increasing income (see Table 9). This difference is really something that management wouldn't want to see if it were counting on one profit stream for earnings per share purposes and was going to wind up getting a different one because of this change in accounting. Here is a situation in which, both on an absolute and a relative basis, there is a significantly higher negative income impact. On a relative basis, you're writing off between 6% and 10.5% more for the first 23 years before things turn around. If you're looking for immediate gratification, this isn't going to do it.

Let me move to the second area that I want to cover with you, and that is the treatment of realized capital gains.

TABLE 8

Example of the Impact of the EITF method on PVP Amortization
Level 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	\$118,059,647	\$240,916,564	\$10,486,935	\$118,059,647	\$21,250,737	\$20,357,836	(\$892,900)	-4.20%	(\$892,900)
2	\$21,400,000	117,910,384	238,789,889	10,486,935	117,017,484	21,223,869	20,274,463	(949,406)	-4.47%	(1,842,306)
3	\$21,400,000	117,734,253	236,493,080	10,486,935	115,891,947	21,192,166	20,184,420	(1,007,745)	-4.76%	(2,850,051)
4	\$21,400,000	117,526,419	234,012,526	10,486,935	114,676,367	21,154,755	20,087,174	(1,067,581)	-5.05%	(3,917,633)
5	\$21,400,000	117,281,174	231,333,528	10,486,935	113,363,541	21,110,611	19,982,148	(1,128,463)	-5.35%	(5,046,096)
6	\$21,400,000	116,991,785	228,440,210	10,486,935	111,945,689	21,058,521	19,868,720	(1,189,802)	-5.65%	(6,235,898)
7	\$21,400,000	116,650,306	225,315,427	10,486,935	110,414,409	20,997,055	19,746,217	(1,250,838)	-5.96%	(7,486,736)
8	\$21,400,000	116,247,362	221,940,661	10,486,935	108,760,626	20,924,525	19,613,915	(1,310,610)	-6.26%	(8,797,346)
9	\$21,400,000	115,771,887	218,295,914	10,486,935	106,974,540	20,838,940	19,471,028	(1,367,912)	-6.56%	(10,165,258)
10	\$21,400,000	115,210,826	214,359,588	10,486,935	105,045,568	20,737,949	19,316,710	(1,421,239)	-6.85%	(11,586,497)
11	\$21,400,000	114,548,775	210,108,355	10,486,935	102,962,278	20,618,780	19,150,047	(1,468,733)	-7.12%	(13,055,230)
12	\$21,400,000	113,767,555	205,517,023	10,486,935	100,712,325	20,478,160	18,970,051	(1,508,109)	-7.36%	(14,563,339)
13	\$21,400,000	112,845,714	200,558,385	10,486,935	98,282,376	20,312,229	18,775,655	(1,536,574)	-7.56%	(16,099,913)
14	\$21,400,000	111,757,943	195,203,055	10,486,935	95,658,030	20,116,430	18,565,707	(1,550,723)	-7.71%	(17,650,636)
15	\$21,400,000	110,474,373	189,419,300	10,486,935	92,823,737	19,885,387	18,338,964	(1,546,424)	-7.78%	(19,197,059)
16	\$21,400,000	108,959,760	183,172,844	10,486,935	89,762,701	19,612,757	18,094,081	(1,518,676)	-7.74%	(20,715,735)
17	\$21,400,000	107,172,517	176,426,671	10,486,935	86,456,781	19,291,053	17,829,607	(1,461,446)	-7.58%	(22,177,181)
18	\$21,400,000	105,063,569	169,140,805	10,486,935	82,886,388	18,911,443	17,543,976	(1,367,467)	-7.23%	(23,544,648)
19	\$21,400,000	102,575,012	161,272,070	10,486,935	79,030,364	18,463,502	17,235,494	(1,228,009)	-6.65%	(24,772,657)
20	\$21,400,000	99,638,514	152,773,835	10,486,935	74,865,857	17,934,933	16,902,333	(1,032,599)	-5.76%	(25,805,256)
21	\$21,400,000	96,173,447	143,595,742	10,486,935	70,368,191	17,311,220	16,542,520	(768,701)	-4.44%	(26,573,957)
22	\$21,400,000	92,084,667	133,683,401	10,486,935	65,510,710	16,575,240	16,153,921	(421,319)	-2.54%	(26,995,275)
23	\$21,400,000	87,259,907	122,978,073	10,486,935	60,264,632	15,706,783	15,734,235	27,452	0.17%	(26,967,824)
24	\$21,400,000	81,566,690	111,416,319	10,486,935	54,598,867	14,682,004	15,280,974	598,970	4.08%	(26,368,854)
25	\$21,400,000	74,848,695	98,929,625	10,486,935	48,479,841	13,472,765	14,791,452	1,318,687	9.79%	(25,050,167)
26	\$21,400,000	66,921,460	85,443,995	10,486,935	41,871,292	12,045,863	14,262,768	2,216,905	18.40%	(22,833,262)
27	\$21,400,000	57,567,323	70,879,514	10,486,935	34,734,060	10,362,118	13,691,789	3,329,671	32.13%	(19,503,591)
28	\$21,400,000	46,529,441	55,149,876	10,486,935	27,025,850	8,375,299	13,075,133	4,699,833	56.12%	(14,803,758)
29	\$21,400,000	33,504,740	38,161,866	10,486,935	18,700,982	6,030,853	12,409,143	6,378,290	105.76%	(8,425,468)
30	\$21,400,000	18,135,593	19,814,815	10,486,935	9,710,125	3,264,407	11,689,875	8,425,468	258.10%	0

TABLE 9
 Example of the Impact of the EITF Method on PVP Amortization
 Income Increasing 2.0% Annually

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	\$132,060,187	\$292,463,713	\$9,663,038	\$132,060,187	\$23,770,834	\$22,301,777	(\$1,469,057)	-6.18%	(\$1,469,057)
2	\$21,828,000	134,431,020	294,460,810	9,856,299	132,961,964	24,197,584	22,608,658	(1,588,925)	-6.57%	(3,057,982)
3	\$22,264,560	136,800,604	296,189,674	10,053,425	133,742,622	24,624,109	22,910,545	(1,713,564)	-6.96%	(4,771,546)
4	\$22,709,851	139,160,153	297,620,288	10,254,493	134,388,607	25,048,827	23,206,446	(1,842,381)	-7.36%	(6,613,927)
5	\$23,164,048	141,499,129	298,720,060	10,459,583	134,885,202	25,469,843	23,495,281	(1,974,562)	-7.75%	(8,588,489)
6	\$23,627,329	143,804,924	299,453,617	10,668,775	135,216,435	25,884,886	23,775,869	(2,109,017)	-8.15%	(10,697,506)
7	\$24,099,876	146,062,481	299,782,577	10,882,150	135,364,975	26,291,247	24,046,923	(2,244,323)	-8.54%	(12,941,829)
8	\$24,581,873	148,253,852	299,665,307	11,099,793	135,312,022	26,685,693	24,307,042	(2,378,652)	-8.91%	(15,320,481)
9	\$25,073,511	150,357,672	299,056,659	11,321,789	135,037,191	27,064,381	24,554,697	(2,509,684)	-9.27%	(17,830,165)
10	\$25,574,981	152,348,542	297,907,680	11,548,225	134,518,377	27,422,738	24,788,226	(2,634,511)	-9.61%	(20,464,677)
11	\$26,086,481	154,196,299	296,165,314	11,779,190	133,731,622	27,755,334	25,005,821	(2,749,513)	-9.91%	(23,214,190)
12	\$26,608,210	155,865,152	293,772,058	12,014,773	132,650,962	28,055,727	25,205,514	(2,850,213)	-10.16%	(26,064,403)
13	\$27,140,374	157,312,669	290,665,613	12,255,069	131,248,266	28,316,280	25,385,167	(2,931,114)	-10.35%	(28,995,517)
14	\$27,683,182	158,488,575	286,778,488	12,500,170	129,493,058	28,527,944	25,542,456	(2,985,487)	-10.47%	(31,981,004)
15	\$28,236,846	159,333,337	282,037,585	12,750,174	127,352,333	28,680,001	25,674,859	(3,005,142)	-10.48%	(34,986,146)
16	\$28,801,582	159,776,492	276,363,746	13,005,177	124,790,346	28,759,769	25,779,633	(2,980,135)	-10.36%	(37,966,281)
17	\$29,377,614	159,734,678	269,671,263	13,265,281	121,768,397	28,752,242	25,853,805	(2,898,437)	-10.08%	(40,864,718)
18	\$29,965,166	159,109,306	261,867,350	13,530,586	118,244,588	28,639,675	25,894,147	(2,745,528)	-9.59%	(43,610,246)
19	\$30,564,470	157,783,814	252,851,572	13,801,198	114,173,569	28,401,087	25,897,157	(2,503,929)	-8.82%	(46,114,175)
20	\$31,175,759	155,620,431	242,515,228	14,077,222	109,506,256	28,011,678	25,859,038	(2,152,640)	-7.68%	(48,266,815)
21	\$31,799,274	152,456,350	230,740,687	14,358,766	104,189,535	27,442,143	25,775,671	(1,666,472)	-6.07%	(49,933,287)
22	\$32,435,260	148,099,219	217,400,668	14,645,942	98,165,931	26,657,859	25,642,593	(1,015,267)	-3.81%	(50,948,554)
23	\$33,083,965	142,321,818	202,357,461	14,938,860	91,373,264	25,617,927	25,454,966	(162,962)	-0.64%	(51,111,516)
24	\$33,745,644	134,855,781	185,462,093	15,237,638	83,744,265	24,274,041	25,207,548	933,507	3.85%	(50,178,008)
25	\$34,420,557	125,384,177	166,553,417	15,542,390	75,206,169	22,569,152	24,894,660	2,325,508	10.30%	(47,852,500)
26	\$35,108,968	113,532,772	145,457,133	15,853,238	65,680,272	20,435,899	24,510,152	4,074,253	19.94%	(43,778,247)
27	\$35,811,148	98,859,702	121,984,735	16,170,303	55,081,455	17,794,746	24,047,361	6,252,615	35.14%	(37,525,632)
28	\$36,527,371	80,843,301	95,932,366	16,493,709	43,317,669	14,551,794	23,499,075	8,947,281	61.49%	(28,578,351)
29	\$37,257,918	58,867,725	67,079,585	16,823,583	30,289,373	10,596,190	22,857,485	12,261,294	115.71%	(16,317,057)
30	\$38,003,076	32,205,997	35,188,034	17,160,055	15,888,940	5,797,079	22,114,137	16,317,057	281.47%	0

Again, for a company like CONSECO, which actively manages its portfolio, this is a very important issue for FAS 97 products. As mentioned earlier, realized gains have to be considered as part of an unlocking exercise for FAS 97 products and, as I've just mentioned, for post-November 19, 1992 acquisitions when you consider FAS 97 products in establishing PVP. There is a general procedure we use.

- Distribute gains to lines of business.
- Add gains to EGP (DAC) or GAAP Profit (PVP) streams.
- Adjust future yields.
- Adjust other assumptions: credited rates, lapse, etc.
- Determine cumulative DAC/PVP adjustment.

First, you would distribute your realized gains to lines of business. I'm responsible for the actuarial numbers for eight of our companies. Allocating realized gains to the company is not a problem. We have statutory portfolios. We know which companies own which assets. We can allocate those things. When you get to allocating by line of business, however, it becomes somewhat trickier. We do not segment our asset portfolio. Our assets are, in general, managed without saying that this line of business owns this asset and this line of business owns that asset. Allocating by line of business is a little tricky.

Further, when we look at recoverability, whether it's for DAC unlocking or FAS 60 or whatever, we also look at pre- and postacquisition lines of business separately. I've been at sessions and I have heard that people, for a single line of business, look at the preacquisition asset and the postacquisition asset together in one test. We don't ascribe to that theory. I personally believe that they are wholly different assets and are recovered by wholly different streams. At any rate, when you look at pre- and postacquisition assets for the same line of business, you've got another allocation problem. At any rate, this becomes the first step in your traditional process.

Second, once you've gone through the process of in detail or notionally allocating capital gains, you would then add those capital gains to your estimated gross profit stream for DAC or to your PVP stream for FAS 97 PVP in post-November 19, 1992 acquisitions. If you've taken capital gains and they are material, you will more than likely have affected the future yield on your asset portfolio, so you want to adjust your future yield assumptions.

Also, you would use this procedure when you go through a full-blown unlocking process. You're also going to adjust credited rates, lapsed rates, and mortality and adjust your model when necessary. Finally, you would then determine the cumulative DAC and/or PVP adjustment that's necessary, because that is a result of this procedure. Again, this is the procedure to use when you have the ability and the time to reproject on a full-blown basis. But what about periods during the year when you just don't have the time?

At interim dates, if you're going to take capital gains, you're going to take capital gains. The investment department and senior management of your company are not going to check with the actuarial department to find out if and when it is going to conduct a full-blown DAC unlocking procedure before it determines that it is going to take significant capital gains. Frequent rejections are just impractical. A practical

expedient then becomes necessary. If you're taking material capital gains, it's probably going to be a material event in the profit stream of your lines of business.

At CONSECO, we've taken a very conservative position by assuming that realized gains are not accompanied by changes in credited rates. The rationale goes something like this. Changes in portfolio rates can be attributed to two generalized types of processes. First, there are changes in interest rates, and those secular changes will affect the portfolio because of new money coming in on periodic premium products, because of premium coming in on new products, because of what I'll term a normal asset roll-overs. There's normally some level of rolling of assets and, depending upon what new money is and how the investment department handles that money, the asset portfolio is going to change. These are events that are frequently accompanied by changes in credited rates.

The second type of event would be discretionary realized gains programs that the investment department and senior management decide are appropriate at given points in time because of the general economic scenario. Other companies may not look at this in the same light. Some companies may want to maintain the flow in the assets. Other companies, such as CONSECO, which very actively manages its asset portfolio and believes that it has done a very fine job in evaluating credit risk, believe it's appropriate to take capital gains. We're saying, those capital gains are not accompanied by changes in credited rates, and you'll see why we rationalize it that way in a moment.

We further say that realized gains change only the incidence of profits, not the total amount. The way we get to that position is by assuming that realized gains represent the present value of a level stream of foregone income for a period of time equal to the years to maturity on the asset you sold.

I know which assets were sold because I get reports from the investment department. Because of the timing of this exercise, I am usually one quarter behind, but the pattern of which assets have been sold is usually very consistent. The amount may be different. We then take this level amount of foregone investment income and allocate it by line of business. A reasonable way of doing this allocation is to allocate it by liabilities.

Now that I've got that foregone investment income allocated by line of business, both pre and post, I'm going to convert the allocated level amount of foregone investment income to foregone DAC and PVP revenue. How do I do that? Well, I take the stream that I've allocated. For example, if my realized gains in total equate to foregone income of \$1 million a year for 20 years and I allocate \$100,000 of that to some postpurchase line of business, say SPDAs sold after my acquisition date, I will now have \$100,000 if my DAC discount rate is 6%, because that's what I'm crediting. I will take that \$100,000 a year for 20 years and I will discount it at 6%. That is a representation for the present value of the foregone investment income that I would have if I were looking at the recoverability of that line of business.

Of course, we're talking about FAS 97 DAC and so I've got a gross amortization percentage. I'm going to use the gross amortization percentage that I've been using since my last recoverability test and, if you follow and believe my rationale, that's

wholly consistent with that rationale. Why? I made the statement that we are assuming that we have changed not the present value of income, but just the incidence of income, so my gross amortization percentage remains appropriate. We will then apply the gross amortization percentage to this present value and that will be what we incrementally amortize as a result of realized capital gains for that particular line of business.

We'll take a similar approach for PVP, except in this case, we'll make the assumption that our gross amortization percentage is not something like 65%, but that it's 100%. Under the theory that if our assumptions have been correct, what we've capitalized is the fair market value of our inventory representing 100% of the gross profits. Again, this is a very conservative approach. The method is intended to be quick and reasonable and not exacting. What's good about this method is that we use it only at interim periods, because when we go for a full-blown unlocking procedure, that cleanses all of our sins. Now instead of using these expedient interim procedures, we're going to go back and, to the best of our ability, restate what actually happened and reproject based on our best estimates as to future experience. Now, again, at the next quarter, we'll go through other interim adjustments and we'll build until our next unlocking exercise.

I'm sure you've come across many issues like this in your companies. If you haven't, you will. I hope my comments have given you a little bit of insight as to how we at CONSECO handle those matters, especially as they affect FAS 97 products.

MR. MARK D. J. EVANS: Did I understand you to say that on doing recoverability on a purchase GAAP, you could drop your discount rate down to the liability rate?

MR. ROSEN: Several companies including CONSECO, are doing that. The procedure has been accepted by the outside auditors. Again, I'm not an accountant, and so I may be speaking a little bit out of school. The theory is that the asset that you're acquiring is like certain other financial instruments and, where the yield has changed, you can adjust your balance sheet similarly. Other companies are doing that.

MR. EVANS: My point is on FAS 97. To come up with the gross margins, you're assuming a spread between the investment rate and the credited rate. On the liability side of the balance sheet you're assuming one rate and you're assuming another rate on the asset side. If you just combined your cash flows so that you just had a unitary reserve, and you discounted that by your investment discount rate, i.e., you did a gross premium valuation, you would then find that if you had a situation in which your P-GAAP asset was based on the discounting at the credited rate, you'd be in an unrecoverable situation by a fair margin.

MR. ROSEN: I think I lost your point. If you've established an asset at a 17% or 18% rate and then you do a recoverability test at an 8% rate, you're going to have a much bigger number and you'll be highly recoverable.

MR. EVANS: I agree with that. But if you've got a situation in which you originally established your asset at 18% and then moved it down to 6% as your block became less profitable, I understood you to say that you could do that. But by the time you

got down to that, you would be highly unrecoverable if you just did a gross premium valuation.

MR. ROSEN: But you're going to be discounting your profit stream at 6%. The reason that you've taken it down to 6% is because when you discount your future profit stream at 6%, that's the way you recover your asset.

MR. EVANS: But you won't be able to recover it. If you're assuming an 8% investment yield, for example, to come up with your gross margins under FAS 97, you can't discount your future profits at 6%. If you would recalculate that by doing a unitary reserve at 8%, you would find that unitary reserve to be quite a bit higher than the net of your fund value and your P-GAAP asset, indicating an unrecoverable situation.

MR. ROSEN: But the 6% is not the same as an asset earnings rate. The 6% is somewhat artificial. It becomes the yield on the asset if my profits, as I currently believe them to be, are realized. That 6% is different than the 7%, 8%, or 5% that I'm actually going to earn on the asset portfolio. It's almost like an internal rate of return.

MR. SCHUERING: We may not be getting your question, but I think one point about the requirements of the EITF ruling is that they are consistent with what was done on FAS 97, which was to insist on using the credited rate on the DAC balances for amortization purposes. They're essentially taking that same point of view, even though it's not logical.

MR. EVANS: Not exactly. If you read FAS 97 carefully, it says that you have to calculate the deferred acquisition costs by using the credited rate. But to do recoverability, they tell you to use something along FAS 60, because the AICPA realized that you could not use a credited rate to do recoverability.

MR. SCHUERING: Right, and ultimately the FASB is assuming that you will use a standard recoverability test. In fact, the new EITF essentially says that for all purchases, regardless of the grandfathering, standard recoverability tests hold. The use of the credited rates refers to just the mechanical computation of the DAC or the PVP.

MR. EVANS: Okay, so you go ahead and do that and then throw that away to do recoverability.

MR. SCHUERING: You can look at standard FAS 97 DAC calculations and usually, if the margin for amortization is much less than 100% and you believe the assumptions, you usually don't have to get too concerned about recoverability. Once that margin gets close to 100%, you should probably do a separate recoverability test by using the present value of expected cash flows and not be bothered by what's in the FAS 97 amortization margin. A standard recoverability test then is the most appropriate thing to use.

MR. EVANS: Okay, and you're saying you did the same thing for P-GAAP.

MR. ROSEN: Yes. We haven't said anything inconsistent with anything that you've said.

MR. EVANS: Okay. I misunderstood something you said earlier.

MR. SCHUERER: I think what Howard was saying earlier was that prior to the EITF ruling, there was another test for recoverability other than the standard gross premium valuation that was acceptable, in which the test for recoverability of the PVP asset was the present value of future profits (prior to amortization of PVP) discounted at interest rates as low as 0%. Those alternate recoverability tests no longer are acceptable. Those other tests have been outlawed with this ruling.

MR. GERALD ANTHONY SCHILLACI: Howard, would the principles of EITF Ruling 92.9 apply equally to acquisition of a life company and an acquisition of a block of business, or are there any distinctions there?

MR. ROSEN: I'm not sure I know. I'll defer to Eric.

MR. SCHUERER: Acquisition of blocks of business is even in more of a gray area than standard acquisition accounting. Many blocks of business end up being more in the way of reinsurance types of transactions, and you usually don't get into purchase-accounting-type adjustments, although you still have to be concerned about recoverability of any imputed DAC you might put up and the overall level of reserves. You normally don't get into questions of PVP.

MR. SCHILLACI: Howard, one other distinction between what you called the traditional method and the GAAP method espoused by 92.9, I think, is the treatment of tax. Wouldn't the traditional method project profits on an after-tax basis, whereas your GAAP treatment would be on a before-tax basis?

MR. ROSEN: No. The traditional approach, at least as I've used it all through my career, is on a pretax basis. The PVP asset is pretax and the amortization would then be tax-affected in the deferred tax calculation because it's part of your income statement.

MS. LYNN ANN POGAS: When you reflect capital gains, you would not ratio them up or down for the difference in the fund balance versus the asset balance.

MR. ROSEN: I guess I'm not sure I understand.

MS. POGAS: When Errol did his example, he had a different amount of assets backing his product in the fund balance.

MR. ROSEN: Right.

MS. POGAS: For his normal investment income that he was going to use in estimated gross profits, he would ratio that up or down. But he said as far as capital gains went, he used the exact dollar amount. He didn't apply that same ratio.

RECORD, VOLUME 19

MR. ROSEN: Yes. We use, at least in our expedient approach, the exact amount of capital gains, because that represents the difference in the income stream. So we would add the capital gains and not some adjusted or ratioed amount.