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CURRENT TOPICS AFFECTING FINANCIAL REPORTING ACTUARIES

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MR. DOUGLAS C. KOLSRUD: Our first speaker will be Dick Robertson. Dick is executive vice president of Lincoln National Corporation. His responsibilities include risk control, asset/liability management, investor relations, and some corporate actuarial duties. Besides his company responsibilities, Dick has taken an active role in the development of insurance accounting and tax issues. He's a former member of the Financial Accounting Standards Advisory Council (FASAC) and has been a leader in the development of standards for managing life insurance surplus. As most of you know, Dick served as President of the SOA during the 1985–86 term and is currently chairperson of the SOA Committee on Discipline and is a member of the Actuarial Standards Board (ASB). Dick will cover actuarial standards with an emphasis on financial reporting issues.

Dick will be followed by Donna Claire. Donna is president of Claire Thinking, Inc., an actuarial consulting firm specializing in asset/liability management, corporate modeling, and valuation actuary issues. Donna has been involved with asset adequacy analysis issues for the past decade and is currently a member of the SOA Board of Governors and the American Academy of Actuaries Life Practice Council. Donna also represents the Society's Committee on Life Insurance Practice Advancement at NAIC meetings and is the official representative to the NAIC for the Academy's Committee on Life Insurance Financial Reporting. She currently heads the Society's Task Force on Life Nonforfeiture and is a member of the Academy's Committee on Life Insurance. Donna will give us a brief overview of current topics at the NAIC, and I know of no one better to address such issues.

Peter Duran will be our final speaker. Peter is a partner in Ernst & Young's actuarial services group in New York, with 20 years' experience in the life insurance industry. He's a member of the Life Insurance Company Financial Reporting Section Council and the Academy Committee on GAAP for Mutuals and currently serves as chairperson of the Committee on Life Insurance Specialty Guides. He's former chairperson of the Committee on Valuation and Related Areas and a former member of the Academy Committee on Life Insurance Financial Reporting. Prior to joining Ernst & Young, he was affiliated with Mass Mutual for 13 years.

MR. RICHARD S. ROBERTSON: One of the more interesting of the qualifications you mentioned was my serving on the Financial Accounting Standards Advisory Council; imagine serving on the advisory council of an organization that doesn't want advice. The topic that I'm going to speak on involves actuarial standards, with particular emphasis on how they affect the financial reporting process.

As you all know, the foundation of our professional standards is the Code of Professional Conduct. And if you're like many of us, you probably have not reviewed that for a while, although since we had the session earlier involving professional ethics, perhaps you had an opportunity to refresh your memory as to the things that are included in that code. Of course, it covers the basics: the concepts of integrity, honesty, thoroughness, professional diligence. It also gets into qualifications, and in particular, requires that an actuary be qualified for any assignment he or she agrees to undertake. In so doing, it encompasses the qualification standards of the Academy and the Canadian Institute. Of course, those qualification standards talk in more depth as to what being qualified means, and they include a requirement that qualifications and proficiency be maintained through a continuing education program. And of course, the Academy does have its program of specified continuing education that actuaries are expected to complete and to keep records pertaining to.

The Code of Professional Conduct also requires that actuaries follow the professional standards applicable to the jurisdiction in which the actuary is practicing. For the actuaries practicing in the U.S., that means the standards that are promulgated by the ASB. I am a member of the ASB and have been for about four years at this point. There are nine board members. The nine members are selected to have representation of all the major areas of actuarial practice: life, property and casualty (P&C), health, and pensions. So whenever a topic comes up, let us say life insurance, we have experts on life insurance there. While that's helpful, it's probably even more important that, when a topic on, let us say, P&C insurance, comes up, there are experts on life insurance and health insurance. We can be sure that the standards that are being adopted in one branch of the profession will mesh with the appropriate standards for the other parts of the profession. Unless it is unavoidable, we don't want standards that apply to an actuary operating in the health insurance area to conflict with the standards that are operating someplace else. Much of the effort that we put on involves making sure that the standards work across the board.

The expertise for developing standards generally rests in operating committees that are established for that function. There are operating committees that pertain to life insurance, health insurance, pensions, and P&C insurance. These are the committees that are charged with the process of developing the standards. These are the committees that examine the comment letters that come back and incorporate them in the revisions of the exposure drafts. These are the committees that basically do all the hard work.

In the process of developing a standard, recommendations or suggestions that standards should exist can come from a variety of sources. They can come from anyplace. Regulators may make suggestions. Individual practicing actuaries may indicate there's a need for guidance in particular areas. The board may make suggestions. And the operating committees are charged with examining the field of practice and determining if there are areas where standards may be appropriate.

Proposals for standards are presented by the operating committees to the board. The board will examine them. It will examine such issues as the appropriate scope of a proposed standard, the kinds of things that might be appropriate to include in the standard. Assuming it approves the proposal, it will send it down to the operating committee to be worked on.

The operating committee will seek guidance from both the board and from practicing actuaries as it goes through the process of developing the standard.

At such time a standard is in shape to expose to the membership, it will come to the board. Generally, the board will spend a fair amount of time reviewing it. It literally goes over it page by page, paragraph by paragraph, sometimes making substantive changes, sometimes making editorial changes. If the draft is approved for exposure to the membership, it will then be distributed to all of you with a comment deadline. There may or may not be hearings scheduled. Probably about half the time we'll have hearings on a proposed standard. There's one tomorrow, for example, here in New York, that relates to the proposed standard on sales illustrations that is being used to support the NAIC regulation that is coming forward.

Comments will be reviewed by the operating committee. A summary of them will be reviewed by the board. The standard will be revised to the extent appropriate to take into consideration the comments and will include a discussion of the comments, as part of the standard, as to why the operating committee, and ultimately the board, chose to make or not make changes that were suggested by commenters. The final standard will be reviewed by the board, again, page by page, paragraph by paragraph, sometimes word by word. And if approved, it will be distributed and will have an effective date that will describe at which time or for which actions of actuaries the standard is applicable.

There are 23 standards in effect at the present time. Seven of those standards are specifically tailored to the financial reporting process. Many of the other 16 also have a bearing on financial reporting, particularly as one gets into a specialized area of financial reporting. The 7 that I identified were numbers 7 and 14, which pertain to cash-flow testing; number 10, which pertains to GAAP assumptions; number 11, which pertains to reinsurance; number 1, which deals with reports to auditors of the relationship of the actuary and the auditor; number 22, which is the standard that pertains to the statutory actuarial opinion; and number 23, which is data quality. I thought about including number 19 on actuarial appraisals on the list, because many actuaries involved in the financial reporting process also advise in merger and acquisition situations. There are others; for example, those that involve how employers account for pensions or health care costs certainly have relevance in the financial reporting area as well.

I am pleased to report that the Committee on Discipline has not been a particularly busy committee during the last couple years, although we have not been idle either. And that's just as well. It is a very high level of responsibility because we're dealing with the professional livelihoods of the actuaries affected, and that's the kind of thing that is very difficult to do. You realize that the actions are going to have a very significant impact on those individuals, and more generally, on the profession as a whole.

I was on the Committee on Discipline prior to the organization of the Actuarial Board for Counseling and Discipline (ABCD), and at that time, the committee had a lot more work to do because it had the responsibility of investigating complaints and allegations of misconduct. And that is a very time-consuming process. The ABCD now has that responsibility. The actions of the Committee on Discipline are limited to taking recommendations for action that the ABCD presents, and determining what kind of discipline is appropriate, given the circumstances.

There is one case we acted on recently that I want to talk about a little bit, although it's not appropriate to go into too heavy a level of detail, because it does involve financial reporting, and it involves the actuarial opinion. This particular case predates the current version of the standard valuation law, so that the opinion at issue relates only to the reserves of the company and does not talk about the asset adequacy or the other requirements that the actuary now has to deal with .

The case is a little unusual in that most discipline issues tend to involve, in some way, a breach of integrity; maybe the actuary had a conflict of interest, or in some cases there is a question of the actuary's motivation. In the case that I'm referring to here, there was never a hint that the actuary was acting in anything but a straightforward manner. The problem was that the actuary just didn't do a good enough job. In forming an opinion on the reserves, there are a number of things that the actuary should have done and did not do. As a result of that, the ABCD recommended to the actuarial organizations that this member belonged to that there be a reprimand. After examining the facts of the case, the Committee on Discipline of the SOA agreed that there would be a reprimand, it would be a public reprimand, and in the next issue of *The Actuary* there will be a description of it.

I have some concern that with the additional responsibilities that have been placed on actuaries that we may have to deal with more cases. I think it is utterly important that an actuary take the responsibilities that are put on him or her by the current valuation law and by the ASB through Standard 22, very seriously, exercise them with a high degree of diligence, and if that is not done, I think it is incumbent upon the ABCD and ultimately our Committee on Discipline to take the appropriate action.

MR. ARMAND M. DE PALO: Dick, one of the things that I'm concerned with is continuing education, which is important. I fully support it, and I think all actuaries should maintain their continuing education. But if you read the Academy recommendations required for accreditation literally, it is very hard to get the explicit courses that you need. Let's say you are in a large company and you have a health area, a pension area, and a life area. You can't get 12 hours in each of those particular areas. As an example, I probably earn 40 hours of continuing education every year. But I can't guarantee that there are exactly 12 hours here and exactly 12 hours there. I think there has to be a broader view. If you're doing a certain level of continuing education in a wide-enough range of subjects, you wouldn't be in trouble because something was not exactly a health subject or exactly a life subject. I'm responsible for an enormous group operation, a large life operation, as an illustration of the company. If I start breaking it down into the different categories, does that mean I need 12 hours of illustration-type continuing education, and 12 hours of health because health is now a subspecialty? I'm also an Enrolled Actuary, and I go to the EA meetings. The meeting offers a tremendous number of hours. There has to be a broader view, especially for chief actuaries. If you get 25 hours of continuing education a year, that's prima facie evidence that you have continuing education, and you should not be forced to, basically, pigeonhole exactly what the subjects are. I hope the bean counters will pay a little attention to this.

MR. ROBERTSON: I agree with you entirely. The primary responsibility that you have, or I have, or any actuary has, is to be proficient in the area in which we are practicing. That requires a level of continuing education that can vary considerably, depending upon our skills, our requirements, and the particular area of practice and how rapidly it is changing. There has been a lot of discussion as to what type of specific continuing education the Academy ought to have for individuals. The number of hours adopted is a symbol of a minimal level that an individual is expected to pursue. I think it is fully expected that level probably will not be sufficient, in most cases. But the important thing is that the actuary establish and maintain proficiency, and that is the ultimate test that the actuary will be held accountable for.

MS. DONNA R. CLAIRE: There are a number of activities of interest to actuaries at the NAIC level. I will summarize some of them.

Life Nonforfeiture Law

For me, the most interesting thing happening at the NAIC is the possible rewrite of the life nonforfeiture law. I know this subject has been around a number of years—it has been on the Life and Health Actuarial (Technical) Task Force (LHATF) calendar since 1986. However, something very exciting has happened to this in the past few months. A number of regulators have recognized that the old ways of doing business may no longer fit today's conditions. Frank Dino has become the head of LHATF, and with the help of a group of other actuarial regulators, has decided to go back to first principles to determine what the basic precepts of a life nonforfeiture law should be. An underlying concept is that persisting policyholders should not be significantly advantaged or disadvantaged by terminating policyholders. In the document they established as the starting place, there are two basic premises:

1. To provide minimum standard of return to the policyholders and not discourage or unreasonably restrict benefits or product design to the public while maintaining basic equity and operating in a sound financial manner.
2. Regulate at the least restrictive level to obtain desired results.

Basic working principles were also developed. The most significant departure from current law is that, while nonforfeiture values are required, cash surrender values may be optional.

At this time, it is also being explored whether the nonforfeiture amounts may be based on a dynamic standard. The SOA and the AAA have set up committees to assist the LHATF working group. I am currently point person for the Society's effort and a committee member of the Academy group, which is headed by Andy Ware of Northwestern Mutual.

Under this new approach to life insurance, it is anticipated that the actuarial certification would be required. The actuary would have to certify as to equitable treatment of policyholders both at the time of policy filing and annually thereafter.

LHATF is working on a fast track. The members are having conference calls every few weeks on this subject. The SOA and the Academy are also expected to quickly respond to the regulators' needs.

At this time, nothing has been firmly established. However, if work in this direction continues, it will remove the artificial constraints that have existed in the U.S. regarding the type of product that could be designed. It will also increase the level of responsibility of the actuary to ensure fair treatment of various policyholder groups.

These changes will also affect valuation actuaries. As new products are designed, there may need to be changes in reserving to accommodate them.

The thought of such radical changes may be disturbing to some. A number of people state, my product is fine—why tamper with the rules? However, we must recognize the new paradigm. New competitors are entering the marketplace; for example, banks appear to be getting into certain insurance products. Consumers are also becoming more sophisticated. Their needs are also changing; more people are living longer and will need money to take care of them in retirement. I would urge any of you who have ideas on how these laws may be changed to write me as soon as possible. We need to seize this opportunity to help develop laws that could carry the industry into the 21st century.

Actuarial Guideline GGG

Actuarial Guideline GGG is a guideline, which means that it is an interpretation of existing law and should, therefore, always have been effective. This guideline covers the definition of the commissioner's Annuity Reserve Valuation Method (CARVM) for products with multiple benefit guarantees. Actuarial Guideline GGG also passed through all the approval levels of the NAIC effective March 1995.

The basic idea is that the present value of each type of benefit, for example, the cash-value benefit, the annuitization benefit, and the death benefits would be valued at the interest rate applicable for that benefit back to the date of valuation.

A warning—GGG is not just a guideline for two-tier annuities—it also affects products such as generic single-premium deferred annuities (SPDAs), which guarantee annuitization. This can cause minimum reserves to be higher than cash values if any additional benefits were offered. For example, this can be true if the annuity value rather than the cash value were allowed for an annuitization benefit of a five-year-certain period. There are a number of companies with such benefits, so it would certainly be beneficial to check out all deferred annuity products to ensure compliance with Actuarial Guideline GGG before the next annual statement.

XXX (Term Insurance Regulation)

What used to be called Actuarial Guideline XXX, which everyone thinks of as a guideline on term insurance reserves, is my next topic. First, it is no longer a guideline; it is a model regulation. Second, it was not supposed to be called XXX; it is now called the model regulation on nonlevel premium or benefit products. Third, it does affect plans other than term insurance; for example, universal life (UL) products with secondary guarantees would be covered by this regulation.

All levels of the NAIC have approved this regulation, effective as of the March 1995 meeting. However, because this is a regulation rather than a guideline, it will not be effective until the states adopt it. There is a possibility that some states may pass it in 1995 for 1995 issues. However, my guess is that it will not become effective until January 1, 1996. Illinois, for example, has stated that a January 1, 1996 effective date is probable.

Recently, I have reread this regulation to see if I understood exactly what it did. This regulation reminds me of the old saying that a camel is a horse designed by a committee. It is not the neatest regulation ever written. However, like a camel, it gets the job done (I think). It does allow for relatively generous select factors to be used in determining mortality. It does require that each segment (defined as a period of time that the premiums are relatively level) be examined separately and will result in generally higher than unitary reserves for products with longer than a five-year level premium.

The biggest warning on this regulation is that it does apply to certain UL products. Secondary guarantees, such as a guarantee that cost of insurance (COI) rates will not exceed x, will trigger the need to check the minimum reserve level under this guideline.

XXX was a long time coming (six years) but it does seem to be a reasonable compromise as to the level of reserves required.

SALES ILLUSTRATION/OTHER TOPICS

A number of other items on the agenda may affect actuaries. I want to briefly mention some of them:

Changes to the Actuarial Opinion and Memorandum

Larry Gorski has proposed a number of changes to the actuarial opinion and memorandum regulation for 1995. These have not yet been adopted by LHATF, but it is possible that you may see some of them in Mr. Gorski's annual letter to appointed actuaries, fondly known as his Halloween surprise. For those of you who operate in New York, the 1994 revisions to New York's Regulation 126 contain some of the suggested changes, such as requested market value of surplus be shown. As an inducement, I would think some of the changes may be discussed in further detail at the Valuation Actuary Symposium in September [1995].

"This state" requirement

At the last NAIC meeting, it was again brought up how hard it is for actuaries to comply with the requirement to meet the minimum reserve standards in the aggregate for each state the actuary is signing an opinion in. Some of this problem has to do with understanding the minimum reserves for each product in each state. Another problem is complying when different states passed laws such as the adoption of the dynamic interest rates in different years. A task force, with Shirley Shao of the Prudential as a key player, is looking into potential changes to the actuarial opinion and memorandum regulation to make this requirement less burdensome.

Risk-Based Capital (RBC), Asset Valuation Reserve (AVR), and Interest Maintenance Reserve (IMR)

The life RBC industry advisory group was disbanded, and a new group was formed under AAA auspices. Eventual projects include examining the health and life RBC factors to ensure that where they differ it makes sense and to reexamine the C-3 RBC charges for life and annuities.

Codification
The NAIC has hired an accounting firm to help examine statutory accounting principles. A number of these issues concern actuarial items. An Academy task force established to look into certain statutory items and to react to certain issue papers issued by the NAIC group. This work is expected to be fairly intense for the remainder of 1995.

Reinsurance
Frank Dino is on the NAIC group looking at various reinsurance issues. Certain 1995 annual statement blanks changes will affect reinsurance, so be on the lookout for these. The ASB is also considering a revision of the reinsurance standard of practice to reflect some of the more creative reinsurance treaties.

Other Annual Statement Changes
Some other changes to the 1995 annual statement include one to the instructions that clarifies the reconciliation that must be done by appointed actuaries between the numbers used in the annual statement and those of the audited supplementary exhibit.

Separate Account Minimum Death Benefit Guarantees
A number of newer variable annuities currently have some minimum death benefit guarantees, whether it be a guaranteed death benefit of the premium increasing by x% a year or one that guarantees the highest value of the account in the last year as the minimum death benefit. There is no current minimum reserving standard. The NAIC has asked the SOA and the Academy to look into this issue, and they are expected to have an answer by the end of the year.

In summary, a great deal is going on at the NAIC that can affect financial reporting.

MR. MARK SWANSON: My question is rather narrow; it's about the actual model regulation that XXX has become. Because you've read it a dozen times, I thought I'd put you to the test here. We're in the reinsurance business so, referring to page 11, Section E, Paragraph 5, there's a phrase that is of interest to us. A reinsurance agreement shall be considered yearly renewable term (YRT) reinsurance for purposes of this subsection if the reinsurance premium rates are independent of both the premium rates and the plan of the original policy. What, precisely, is independent?

MS. CLAIRE: I could tell you the background of this, and you can figure out whether it applies to you. In effect, some YRT had guaranteed premiums for the next ten years within the contract, and there was very little way for the party to get out of it. Specifically, if you have YRT rates going against a COI product, I wouldn't worry much about it.

MR. SWANSON: I didn't think so, but there have been debates within our company, and one interpretation has been, if you say that your YRT reinsurance rates are 60% of the COIs—

MS. CLAIRE: I'll put it this way: if the COI has secondary guarantees, you may be subject to this. However, if it's just 60% of the COIs, and the product that you're reinsuring doesn't have secondary guarantees, I wouldn't worry all that much about it.

MR. SWANSON: I know.

MS. CLAIRE: That's not what they're going after.

MR. SWANSON: I understand. That wasn't in my interpretation either.

MR. CHARLES E. MOES, JR.: I'm looking at the second one, in the basic principles for the possible new life nonforfeiture law. It says, minimum standard of return for the payment of premium in early years for future benefits. Could you give us a couple of examples of what they're thinking of here?

MS. CLAIRE: This is actually one of the reasons why the SOA Task Force was formed. At the time, the regulators were looking at it only as a retroactive method, as a fund-based approach, looking at it like UL, you have a fund, and you're supposed to get $\$x$ dollars back. Next week we're going to present that this is not the best way to look at equity. This is saying it's equity between the policyholder and the company. You give the company $1,000, and you expect to get back something for that $1,000 if you terminate early. What we discovered is if you look at this entire list of basic principles, some of them conflict with each other. And we are going to point that out to them. We do, however, salute this as a basic concept.

MR. BARRY L. SHEMIN: Donna, could you be a little more specific about the aspects of Regulation 126 in New York that will be carried over? Are we talking about the restricted aggregation or the ten-year cash-out on SPDAs or some of the reporting when you fail a scenario?

MS. CLAIRE: The reporting of the failed scenario is actually one thing that's going to probably be carried over. There are a few things, such as the ten years on the SPDA, that were New York-specific. But the failing of a scenario is one thing that is part of the Larry Gorski proposals.

MR. KOLSRUD: I have a couple questions on RBC. The C-2 factors for health insurance are being reviewed. Could you give us an update of that? And, I guess more broadly and long term, do you see any possible changes coming down the road in the C-3 factors? You don't hear too much about C-3. Most of the discussion has been about C-1.

MS. CLAIRE: The Academy State Health Committee developed health insurance factors, C-2 factors, for RBC, again working closely with the NAIC. They were not consistent with the life RBC. At this point, both groups are looking at it. Guesses are, assuming they did do more work, health will be closer to what eventually comes out. On the C-3 factors, it is a longer-term project, but it's actually one that is definitely on the list. Those factors were the best guess at that time, but it probably does need some more research as to what reasonable factors are for the various types of products. For example, the annuities are split into those with market-value adjustments, those with significant penalties, and those which could have book-value cash-outs. The question arose, where does a two-tier annuity fit? The answer, at this point, was that nobody knew, or everyone had an opinion, but it wasn't necessarily the same one. So more work does need to be done on C-3. It will not be completed this year but it is on its list of projects to do.

MR. J. PETER DURAN: I will talk about recent GAAP developments, specifically, several issues surrounding *FAS 115,* including deferred acquisition cost (DAC) and reserve offsets that are required by the SEC. I'll also speak about deferred tax offsets and the interaction, or lack thereof, between *FAS 109,* Accounting for Income Taxes, and *FAS 115.* I also want to say a little bit about goodwill and about a proposed statement of position (SOP) that has been produced by the AICPA and is now at the FASB. It pertains to accounting for guaranty fund assessments. Also, a new SOP was promulgated at the end of 1994 on disclosures about risks and uncertainties. Finally, I'll address auditors' opinions on statutory financial statements. I will talk about mutual GAAP, per se, because there's a whole session on that topic.

A fairly nonscientific survey of large stock companies that Ernst & Young conducted recently revealed that most companies are classifying most of their debt securities as available for sale. With a few exceptions, the available-for-sale category for the large stock companies comprises at least 90%, often 99% or 100%, of the debt security portfolio to which *FAS 115* applies. So, conversely, there is less than 10% in the held-to-maturity (HTM) category. The trading category classification is virtually nonexistent. It will be interesting to see when the mutuals adopt GAAP, whether they'll have a different profile. I think many large mutuals have talked about holding substantial portions of their assets in HTM. We'll see if that actually happens.

We started out at December 31, 1993 in an environment with low interest rates. Interest rates went up 200 points or more during 1994. Virtually all companies went from an unrealized gain position to an unrealized loss position. The impact, of course, varied widely from company to company. Again, based on a not very scientific survey, we estimate that equity decreased during 1994 on the order of 15–35% for that same group of large stock companies due to *FAS 115* effects. Needless to say, I think most people, not only actuaries, would say there wasn't a deterioration in the financial condition of those companies on that order. I think we're seeing the very predictable and predicted effects of *FAS 115* showing fluctuations that are not entirely real.

The SEC was instrumental in urging the FASB to adopt *FAS 115*, and the SEC has some very specific views on *FAS 115.* For securities classified as HTM, there are six enumerated instances when you can sell the securities out of the portfolio without "tainting" the remaining HTM portfolio. This means that if a company sells an HTM asset without a good reason, that could taint the entire portfolio and the company would have to reclassify the entire portfolio as available for sale. One of the examples that came up this year was a tender offer. You cannot accept a tender offer without tainting the portfolio. The SEC is taking a very narrow interpretation of permissible reasons for selling out of the HTM portfolio; namely, it believes there are the six enumerated reasons and no others. It would seem that the SEC believes that companies should be able to anticipate virtually everything when they classify securities as available for sale. Also, actuaries generally have a hard time understanding why even a very small number of sales out of the HTM portfolio should taint the entire remaining portfolio. In this case, a company could not establish a new HTM portfolio for several years according to the SEC. The SEC staff also believes that *FAS 115* prohibits general reserves for credit losses on bonds. Most companies reporting on a GAAP basis did not have general reserves for bonds, but a few did. A number of mutual companies had been thinking seriously about establishing such reserves. I don't think we're going to see general reserves on bonds. Finally, if you have unrealized losses on your available-for-sale securities as of the statement date and you intend to sell a particular security, then you have to report that as a write-down through income for that particular statement period.

A couple of points on DAC and reserve offsets. The "thought experiment" that you're supposed to go through in developing the shadow DAC, or reserve offsets, is to pretend you sell the available-for-sale assets as of the financial statement date and imagine what would happen. Assuming you're in an unrealized gain position, and if you sold the assets, you'd have a realized gain and you would then have lower investment earnings in the future because, in theory, you'd reinvest at lower rates. This was the situation at the end of 1993. At the end of 1994, it was the other way around. You'd realize a loss, and you'd reinvest at higher rates. In either case, one can make a good argument that the present value of the margins would not change materially, but would change only the timing of their recognition. As a practical matter, many companies are estimating the *FAS 115* DAC adjustment as being equal to the amortization rate times the unrealized gain or loss. So, if we need 85% of gross profits to amortize the DAC, for example, on a block of UL policies, then we take 85% times the unrealized gain or loss. The assumption is that if we were to realize the gain or loss, the present value as of the issue date of the contract of the gross profits over the life of the contract would not change. And most of the time you can convince your auditors that is probably true. On mutual GAAP business, in doing your present values for expected gross profits, you have two options for the discount rate. One option is to lock in the expected earned rate at issue. The other option is to let it float. If you choose the option of letting the discount rate float, then when you realize a gain or a loss you can cause a severe distortion or blip in the discount rate. It's not true anymore that the present value of the gross profits doesn't change. So that ought to be a consideration in choosing which of those two options to avail yourself of.

A couple of points should be kept in mind when calculating a *FAS 115* reserve and DAC offsets. First, when calculating a DAC offset, it is necessary to take the unrealized gain or loss and actually allocate an appropriate portion of it to the business that has a DAC. (Similar remarks apply to reserve offsets). A company might have an unsegmented asset portfolio, only some of the business may have DAC associated with it. Some of the assets back surplus. Some of the assets back products that don't have DAC. Some of the assets back products where the DAC has already been fully amortized. So you have to allocate the assets, and therefore, the unrealized gains and losses, to the business on which you're doing the offset. Of course, there are various methods to do that. In general, I believe you'd want to be consistent with the asset allocation method that has been used for determining the gross profits.

Another point is that *FAS 60* business, in general, is not affected by these *FAS 115* reserve and DAC offsets. I believe, however, that there is one exception to that. If the company was in a very severe unrealized gain position and it was to sell the assets, it could happen that after it reinvested the proceeds, the resulting portfolio wouldn't be able to support the DAC anymore, or support the reserves, in the case, let's say, of immediate annuities. In other words, there could be a loss recognition situation if the assets were sold. In this case, the theory would say that the company ought to write down DAC or set up an additional reserve. This shadow DAC or reserve offset would reverse next year if the unrealized gain were, say, to go down and become an unrealized loss. *FAS 115* adjustments are not permanent. One looks at the position at the end of the current accounting period, and that's the only thing that matters. It doesn't matter where you were last year in order to calculate the DAC and the reserve offset at the end of the current year.

Let me make a couple points on deferred taxes. An unrealized gain or loss on available-for-sale securities gives rise to a deferred tax liability or asset, and that's nothing new. We've had equity securities valued at market with deferred tax assets and liabilities for a long time. Now it's more a question of magnitude. When you have, in some cases, the entire bond portfolio of a company at market, these deferred tax offsets can become very large. When you have an unrealized gain, you have a partially offsetting liability. It represents the tax you would pay if you were to realize the gain. When you have an unrealized loss, you have a partially offsetting deferred tax asset. It represents the capital gain recovery if you were to realize the loss. Now *FAS 109* says that deferred tax assets have to be evaluated for recoverability. And because these are capital losses that we're talking about, what the recoverability requirement comes down to is that there needs to be offsetting capital gains available, unless the company can hold the assets until maturity. So, let's say we're at the end of 1994, and we have an unrealized loss on our securities. We set up a deferred-tax asset. Well, how good is that asset? We will only be able to get the benefit of the capital loss if we have offsetting capital gains. At the end of 1994, if we were to look back three years for capital gains, chances are many companies would have substantial realized capital gains in those years. And so, at the end of 1994, we could make a good case that the asset would be recoverable, in many cases. Of course, it depends on the facts and circumstances of the particular company. I'll come back to that.

A couple of the problems that have surfaced recently with respect to the interaction between *FAS 109* and *FAS 115* have to do with changes in tax rates. The Republicans are talking about lowering capital gains tax rates. However, *FAS 115* clearly states that if there is a change in a deferred tax asset/liability due to a change in capital gains rates, then the effect goes through income. So we have deferred tax assets and liabilities due to *FAS 115*. Those assets and liabilities never went through income and but if there's a reduction in the capital gain tax rate, the effect will go through income. For example, if we have currently a deferred tax asset, and that gets reduced because the capital gains tax rate goes down, there is a hit to reported income, not equity directly.

Coming back to this idea of valuation allowances, *FAS 109* also says that a change in a valuation allowance resulting from a change in judgment about circumstances goes through income. A good example could be our unrealized capital losses at December 31, 1994. Perhaps we didn't establish a valuation allowance because we had realized capital gains in the prior three years. Even if interest rates were to remain level over the next three years, those realized capital gains would have expired, with the result that we might change our judgment about our ability to offset the loss if it were to be realized. As a result, if we established a valuation allowance, that would be another hit to income. Many companies are thinking very carefully right now about just how conservative they want to be in setting up valuation allowances. On April 11 [1995], the FASB did have a public hearing to talk about some of the problems created by *FAS 109;* in particular, the interaction with *FAS 115*. I wish I could report that the board decided to fix the problem, but at the current time, that isn't the case. It is thinking about the issue.

My next topic is goodwill. As you know, goodwill results from a purchase. It is equal to the difference between the fair value of the assets acquired, including the value of the business acquired, less the liabilities. A 40-year straight-line amortization period has been very common for amortizing goodwill. During the last year, the SEC, however, has challenged such amortization when it thought that the business was not going to have a 40-year life. Also, a new FASB pronouncement, *FAS 121,* deals with accounting for long-lived assets, plant, and equipment. *FAS 121* does not address financial assets. DAC is explicitly excluded from its scope, so it has only minimal impact on life insurers. But it does address goodwill, and gives a test for recognizing goodwill impairment that's a little bit difficult to interpret. I'll just say that the test requires the recognition of an impairment when the sum of the future cash flows is less than the value of the asset. The way I would interpret that is that the future cash flows from the acquired entity would be less than the value of the goodwill. It would not seem that test is going to come into play very often.

The guaranty fund assessment SOP is not out yet, so it's not final, and it might change. But it's gone through the AICPA, and it's now being reviewed by the FASB staff, so it's far down the road. Depending on whether the company is a P&C company or a life company, there are different bases for guaranty fund assessments. In the case of life insurance companies, the guaranty fund assessments are often a function of premiums written during a period of years, such as three years, prior to the insolvency for which the assessments are being made. A liability should be established only after there has been a formal declaration of insolvency. The AICPA doesn't want companies setting up liabilities for guaranty fund assessments with respect to companies that might go insolvent but haven't yet. So there has to be a formal declaration of insolvency. Also, the company has to have the ability to estimate its liability, which I guess is another way of saying "how big is the hole?" So if you know this, and you know what your share would be, and you have the ability to estimate your liability, then you should do so. The liability recognizes all guaranty fund assessments to be paid in future years. So if payments will be spread over five years, you have five years' worth of payments to recognize on your GAAP balance sheet. One of the somewhat controversial provisions in the SOP is that the current version allows companies to set up an offset to the liability to recognize future premium tax offsets, which in some states can offset guaranty fund assessments. A final point is that the liability may be discounted, but if this is done, you have to discount the asset as well. There is no guidance on what rate to use in the discounting.

As I mentioned, there is also an SOP that came out at the end of last year [1994], concerning disclosures about risks and uncertainties in the financial statement. This turned out to be not as big a problem as some had feared. It was feared at one time that an insurance-specific supplement to this SOP would require insurance companies to go into overwhelming detail about their risks. Apparently, that won't happen. There is just one SOP and it applies to all companies. First, companies are required to talk about the nature of their operations. There's nothing new here that wouldn't be in a typical management discussion and analysis. Second, there is also a boilerplate disclosure that accounting sometimes uses estimates. That's very enlightening! Third, there has to be a discussion of significant estimates in the financial statement. I think that requirement could have some actuarial fallout. For example, the SOP specifically notes that the deferred acquisition cost asset is an asset that is developed by using estimates. If there is a "reasonable possibility" that the estimate could change in the near term, meaning over the next year, and the effect of that change would be material, then you have to disclose such a possible effect. Oftentimes the deferred acquisition cost asset is built based on best-estimate assumptions, but we know that there is a reasonable possibility that those assumptions might not come true. Disclosure would be required in that instance. Fourth, the last type of disclosure required by the SOP, which I don't think will affect life insurance companies very much, is disclosure about vulnerability due to concentrations. For example, if most of your business came from one broker, you'd have to say so. The SOP is effective for 1995.

The final topic I will discuss has to do with auditors' opinions on statutory financial statements. In April 1993, FASB issued Interpretation 40, stating that auditors couldn't give clean opinions on statutory financial statements after the effective date of the interpretation date. But it didn't say what the form of the opinion would be. There is now an SOP in the final stages of development that will clarify the form of the auditor's opinion on statutory statements. There are different rules for general distribution opinions and for limited distribution opinions. Limited distribution opinions are opinions that are intended only for the board, for management, or for state regulators. For a limited distribution opinion, the company can get a relatively clean-looking opinion. That opinion says that the financial statements present fairly the results of operations on the basis of the accounting described in Note X. Note X would describe, in general terms, statutory accounting. The problem is that you cannot share that relatively clean opinion with the public. If it's a general distribution opinion, you get nasty-sounding language. It says that the statements do not fairly present the results of operations in conformity with GAAP. That has led some mutual companies to speculate that when policyholders call up the company and want a copy of their audited statutory statements with a clean opinion that they will simply reroute the call to the state insurance department and ask the regulators to send it to them, because the regulators will have the clean opinion.