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Editor's Notes

by G. Thomas Mitchell

Spring is in the air, and the confusing and perhaps not so gentle aromas of fair value accounting, derivatives, risk management and equity linked contracts are intermingling in the atmosphere. See Tom Campbell's update on AICPA happenings, including FAS133, and Hans Wagner's letter to the editor. David Becker's treatise on proper ways to look at management of surplus is repeated from the *North American Actuarial Journal* because of its importance. His ideas have considerable interconnections with the aforementioned issues.

This issue also includes the second half of Glyn Holton's review of Value At Risk (VAR), focusing on practical modeling considerations.

US regulatory developments continue at a rapid pace. Harold Forbes returns to the COLIFR Corner, and Larry Gorski offers suggestions on implementation of determining select mortality valuation factors for term insurance and related products under the US (NAIC) new guideline XXX.

Steve Patzman offers the interesting results of a survey of management reporting practices by actuaries.

Your Section has been active, particularly in helping shape the development of the new Society of Actuaries examination system (Larry Gorski reporting on this also); and more well-received seminars globally. Ed Robbins reports on the Buenos Aires seminar from late 1998.

The best news of all for your editor is that Tom Nace has agreed to succeed me in that position. I have enjoyed the responsibility, but a total of eight issues is enough. Tom will assist me in the next issue, and I will reciprocate on the following issue, then retire. The Section is very pleased with Tom Nace's decision. The one regret is the total inability of the Section to find an editor not named Tom (this makes three in a row).

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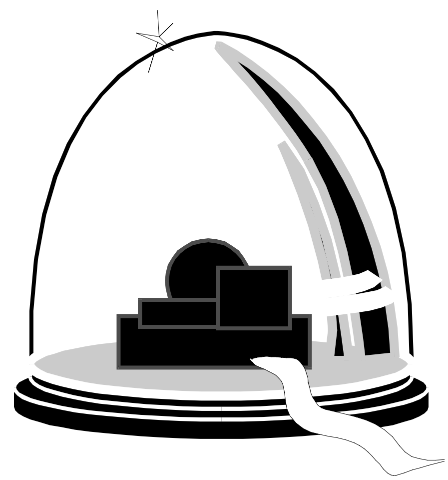
AICPA Non-Traditional Long-Durations Contracts Task Force—A Status Report

by Thomas Campbell

The Non-Traditional Long-Duration Contracts Task Force (Task Force) of the American Institute of Certified Public Accountants (AICPA) is in the process of developing a proposed Statement of Position (SOP) that will provide guidance on the GAAP accounting, reporting and disclosure for many of the innovative insurance products that have hit the market in recent years. The Task Force, which is a subcommittee of the AICPA's Insurance Companies Committee (ICC), includes representatives from the insurance industry and from public accounting firms. This report will outline the efforts of the Task Force.



Statement of Position

Many of the new products in today's marketplace provide new twists to traditional insurance products. One example is an equity-indexed annuity, which includes elements of a traditional fixed annuity (e.g., a guaranteed interest rate) with a contingent additional return based on an external index, such as the S&P 500. Most companies account for these new products by applying existing GAAP accounting standards, such as FASB Statements No. 60 or 97. Unfortunately, most of these new products did not exist when these standards

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AICPA Non-Traditional Long-Duration Contracts Task Force

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were developed, creating inconsistent GAAP accounting and reporting among different insurance companies.

The new products the Task Force has been focusing on include:

- variable annuities with minimum guaranteed death benefits (MGDBs)
- variable annuities with guaranteed living benefits
- equity-indexed life and annuity products
- bonus interest rates and persistency bonuses offered with life and annuity products
- modified guaranteed life and annuity products (i.e., products with market value adjustments) and
- synthetic GICs

Further complicating the accounting for these products is the fact that some contain elements of both general account and separate account products. For instance, variable annuities with MGDBs are written in a separate account, but the MGDB is typically guaranteed by the insurer's general account. Further, some products, such as equity-indexed annuities, can be written as either a general account or a separate account product.

In order to address this issue, the SOP is expected to include guidance for the classification and valuation of separate account assets and liabilities, including the treatment of seed money. In particular, the SOP will address the application of paragraph 54 of FASB Statement No. 60, which states (note that paragraphs 45-51 referenced below provide guidance for valuing assets of the insurance enterprise's general account): *Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statement of the insurance enterprise.*

Appendix I summarizes the GAAP accounting topics which are expected to be addressed in the SOP.

The Task Force is currently focusing efforts on developing conclusions to these issues and creating a draft SOP. Once it is completed, the SOP will need to be reviewed and approved by the ICC and the Accounting Standards Executive Committee of the AICPA (AcSEC), and ultimately exposed for comment (currently targeted for the fourth quarter of 1999).

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FASB Statement No. 133 Implementation Issues

In addition to developing the SOP, the Task Force was asked to raise potential issues facing insurers related to the implementation of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (FASB 133), which was released in June 1998 and is effective for fiscal years beginning after June 15, 1999. Although FASB 133 deals primarily with the asset side of the balance sheet, the FASB's Derivative Implementation Group (DIG) is providing guidance on how FASB 133 should be applied to liabilities for insurance products.

The source of applying FASB 133 to insurance products is contained in Paragraph 12 of the Statement. Paragraph 12 states that contracts (such as bonds, insurance policies and leases) may contain "embedded " derivative instruments, which are defined as "implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. Such a contract is referred to as a hybrid instrument consisting of an embedded derivative and a "host contract". The Statement requires embedded derivatives meeting certain criteria (which are outlined in Paragraph 12) to be accounted for separately from its host contract as a derivative instrument.

In December, the Task Force forwarded a list of issues regarding the application of FASB 133 to insurance products to DIG for consideration. For each issue, the submission included discussion of and arguments for various positions. Over the next few months, DIG will review the issues (along with several other non-insurance product issues) and recommend a position to FASB.

The seven FAS 133 implementation issues raised by the Task Force are summarized in Appendix II. More detail on the issues and positions is available from the FASB website.

GAAP Accounting Topics Being Considered for Draft SOP by the AICPA Non-Traditional Long-Duration Contracts Task Force

1. Under what criteria should Separate Account (S/A) assets and liabilities be valued at market under per paragraph 54 of FASB 60? Under what criteria should they be valued as if they were in the general account?
2. Under what criteria should S/A assets and liabilities be reported as summary totals in financial statements under paragraph 54 of FASB 60? Should there be a separate summary total for S/A with guarantees that meet this criteria? Under what criteria should they be reported as part of the general account?
3. What disclosures should be made for S/A assets and liabilities?
4. How should S/A seed money be classified and valued?
5. Should a variable annuity with a minimum guaranteed death benefit (MGDB) be reported in the S/A? If so, should an additional reserve (above account value) be held in the general account? Is an MGDB considered a guaranteed benefit? How should the benefit be treated for purposes of amortizing deferred acquisition costs (DAC) and testing recoverability of DAC under FASB 97?
6. How should modified guaranteed annuities (MGAs) be reported? Should the liability be reported at book, at market, or at the greater of book and market? Should MGAs written in the S/A be reported differently from those written in the general account?
7. How should bonus interest rates and persistency bonuses offered with life and annuity products (fixed and variable) be expensed? Should bonus interest rates at issue be handled differently from persistency bonuses offered in later contract durations?
8. How should Synthetic GICs be classified and valued?
9. To the extent they are not covered by FASB 133, how should Equity Indexed Annuities and Equity Indexed Life Insurance products be classified and valued?
10. How should the reinsurance of non-traditional products be classified and valued?

FASB Statement No. 133 Implementation Issues Raised by the AICPA Non-Traditional Long-Duration Contracts Task Force

1. Does the conclusion that traditional variable annuity products do not contain embedded derivatives remain valid given the fact that paragraph 200 incorrectly states that the policy holder owns the investments supporting variable annuity products?
2. How is the host contract in a nontraditional insurance or annuity contract determined and is it a debt or an equity instrument? For example, is a variable annuity with a guaranteed living benefit a debt instrument with an embedded equity derivative?
3. Pursuant to the fourth bullet of paragraph 200, is a nontraditional payment alternative available with a traditional variable annuity an embedded derivative, required to be accounted for separately?
4. Are the market value adjustment features contained in modified guaranteed annuities "clearly and closely related" (which impacts whether it meets the Paragraph 12 criteria) to the host contract?
5. Does an equity-indexed life insurance contract contain an embedded derivative (as an equity-indexed annuity does), or is it excluded from being subject to FASB 133 because it contains a death benefit provision?
6. For hybrid UL-type contracts, does the requirement to separate the components of the contract into the host contract and derivative apply only for liability valuation purposes, or does it also apply to the application of FASB Statement No. 97 DAC amortization and loss recognition?
7. With respect to insurance and annuity contracts having embedded derivatives, if the sum of the value of the host contract and the embedded derivative is less than the contract account value, should the aggregate liability be increased to the account value, as required by FASB Statement No. 97?

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