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Summary: The panelists address recent, current, and proposed activity in the life insurance company financial reporting environment.

Mr. R. Thomas Herget: I'm executive vice president at Polysystems. I'm chairman of the Financial Reporting Section and your moderator. We have divided this session into statutory, tax, and GAAP. We try to slice it many different ways, but it always comes back to that threesome. Our first speaker is Craig Raymond. Craig will be talking about statutory. He is senior vice president and chief actuary at The Hartford, and he is the company's appointed actuary. He has been with The Hartford since 1989. Craig is the former Financial Reporting Section chair and is currently chairman of the Academy's Committee on State Life Insurance Issues and a member of the SOA Board of Governors.

Mr. Craig R. Raymond: There is a lot going on at the NAIC, and it amazes me just how much activity (good and bad) there is. There's a lot going on in the industry—a lot of change and a lot of need for change. Unfortunately, the regulatory process is one that's very difficult to move forward quickly, but for those of you who don't spend a lot of time working within the regulatory system, one thing that's important for you to realize is it is possible to get things done and to get changes made. It takes a lot of effort, activity, and education. We're going to talk about some of the things that can help make that happen. I encourage you, as we go through this, to think about where you have opinions and where your voice needs to be heard. Get involved in the process and talk to people about it. Talk to regulators, make your opinions known, and volunteer.

Tom mentioned I'm the chair of the Committee on State Life Insurance Issues at the Academy. One of our most pressing issues is we have so many requests for help coming from the regulators, but the amount of assistance they're looking for us to provide to them is much larger than the number of volunteers we have to do the work. That's a little pitch, and I want to encourage you to keep that in mind.

Bob Wilcox, Jim Reiskytl, and Larry Gorski talked about the proposal for the new valuation law and went into a great deal of detail. I'm going to give you some thumbnail sketches and some updates. If anyone has any specific questions, we can get back to those later, but I'd like to cover as much of this as possible to give you a feel for what's going on.

There is a proposal for a revision to the standard valuation law. For those of you who aren't familiar with it, this resulted from a charge that was given to the AAA in December 1997.

Eighteen months ago the NAIC requested that we essentially start with a blank sheet of paper, look at the valuation law from a fresh perspective, and come back with a proposal. In some ways, the Academy as a group started with more of a blank sheet of paper than some had expected, and we really went back to some basic concepts to look at valuation. A final report was presented two weeks ago to the NAIC that laid out a proposal and a draft model that basically recommended stepping back totally from the current valuation system and looking at the underpinnings of what regulators need from valuation.

What does valuation mean? When we talk about valuation we're talking about valuation in the broadest sense, not just valuation as to how I calculate, but how I calculate the reserve number that goes into the balance sheet. We are talking about valuation from a point of view of what information the regulators and company management need to know in order to achieve the purposes of the valuation system? The purposes are to make sure that we have a viable operating entity, that the regulators get the information they need to monitor the companies, and that there's a regulatory trigger if there's a problem and they need to take action. My personal spin on where the report hits is that underlying the actual statutory accounting rules, the actual statutory reserve methodology that we have right now is really not the most significant item in that whole structure.

The proposal for the valuation law really talks about what we call a universal valuation system, which looks at the entirety of the company and the entirety of the information to get to the point of making sure that information's provided. The focus is on bringing in more actuarial judgment, establishing reserve levels and trigger levels that are based on actuarial judgment, using modeling, and looking at probabilities of survival of the company.

There are many questions as to how much judgment should be involved in the process. What type of accounting system should be used? The proposal presented several different options for the regulators to consider. Bob Wilcox spent an hour on this and did a great job. I can't explain this whole proposal in two minutes, but essentially it moves us away from the statutory formula-driven basis that we have now to one that's based much more on actuarial judgment. This proposal ensures that we're providing information to people rather than just checking to make sure we follow formulas. The underlying accounting system for that is not necessarily the most important item in it, but that is one of the issues that it needs to resolve.

My understanding is that the regulators give positive feedback at the meeting and expressed an interest in moving forward and continuing to flesh out the details, to see if it can work. There are a couple of outstanding issues. There are some within the industry who are strongly opposed to the proposal.

There is a strong desire among a number of the people involved that if a major change like this is going to take place, it needs to be done throughout the insurance industry, and it needs to involve not just life and health insurance but also the casualty side. There has been some concern expressed from both the casualty actuaries as well as the casualty regulators that this system doesn't fit for them and that they need to look at it further. It's my understanding that there will be some discussions at the NAIC level to determine whether this project should include the casualty side as well as the life side.

I think I've already taken more time than I have for that one issue, but if you have more specific questions, we can get back to them later. Also, if you are interested in this, and you missed Bob's presentation, get a copy of the report from the Academy and take a look at it. The members of the committee will be glad to talk to anybody who has questions about our progress and what's happening. If you have opinions, I encourage you to voice them. We have tried to keep this as open a process as possible and to get as much input from as many quarters as possible which is a very important piece of any movement forward. Another important piece in the puzzle is whether we can get changes in the regulatory system. Each of you need to decide for the industry to get to where it needs to be in the future—whether the regulatory system needs to change or not.

Let's discuss the things that need to change. There have been discussions about the Actuarial Opinion and Memorandum Regulation (AOMR) for a number of years. These discussions started from two issues that came from a number of companies concerned about the fact that the actuarial opinion required them to sign a statement that they meet the minimum standards in the state of filing. This is often referred to as the this-state or the 50-state opinion. There are a number of companies that have raised concerns about that as far as their ability to have the information and to make that statement. At the same time there were a number of regulators who were raising concerns about the limitations and the requirements for Section 7 opinions. Theses are essentially the companies that are exempted from doing the cash-flow testing. There were a number of regulators that felt that they needed to tighten that and require more testing to be done in more situations.

Although it has been very carefully stated from the regulatory side that the 50-state opinion and 7 section opinion aren't tied together, they effectively have been because we're not going to get a change to the AOMR unless we can resolve both of those issues. There was discussion on this in Kansas City at the last Life and Health Actuarial Task Force (LHATF) meeting. There is significant movement forward on requiring gross premium valuation in more situations for companies that do not do required cash-flow testing when we do gross premium valuations. In order to solve the controversy surrounding the this-state opinion, the regulators and the industry group have been working on a proposal that will change the regulation to allow an opinion in which you meet the standards in your home state and file a second set of reserves based on a benchmark. The hard part is figuring out exactly what that benchmark means.

The idea here is that a regulator from outside your home state wants to have some information so that he or she can tell what's in your reserves. That is because the California regulators don't necessarily know what the Michigan reserve standards are. If they get an opinion from you saying that you meet the minimum standards in Michigan, they don't know what that means. What they're looking for is some information to help get a basis of comparison to understand whether they like your reserves or not if they're not going to get an opinion from you on their standards. The difficulty is trying to put together a benchmark that's meaningful. There's a small group of regulators that, with some industry help, is trying to define a reasonable benchmark and base it somewhat on codification measures and earlier models. It sounds easy saying we'll use codification, and for precodification rules we'll use the NAIC models, but then you have to ask, what about the models that no states have ever adopted? Do I have to use them? What about effective dates? The NAIC models don't really have effective dates. Every state adopted models at different times. What is a benchmark standard? How you put together the standard is a difficult issue, and they're continuing to struggle with that. I hope that they can make meaningful progress so that we don't end up providing the regulators with an extra set of numbers that don't tell them anything.

Regulation XXX is a wonderful issue. For those of you—who don't know what XXX is, this was the regulation that essentially defined reserves for term insurance. I guess it technically did more than that, but that's really the basis of it. This has been hanging out there for a number of years now. I want to remind people of XXX because it seems to get lost in much of the discussion lately. The efforts on XXX really started seven or eight years ago. It was a long time ago. There was an industry group that worked for years to get this compromise put together. They spent a couple of years compromising and working this out with the NAIC. They eventually got XXX adopted at the NAIC, but then everybody started fighting about it, and a number of consumer groups came out, against it. It has only been effective in a modified version in New York. A number of states have followed Larry Gorski's lead with the 51% rule, which would mean that the regulation will become effective when states that make up 51% of the population have adopted it. I believe it's up to 35% now.

What really has caused a lot of concern recently is the fact that there are only two states that have effective dates of January 1, 1999. There are a number companies that are concerned that if we have uneven adoption of XXX and an unlevel playing field, it will be adopted haphazardly. Whatever the rules for reserving are, we need to have some level of consistency. It won't be effective in a significant number of states on January 1, 1999, but it will be effective in Wisconsin and West Virginia.

From the Floor: Right.

Mr. Raymond: Is that right?

From the Floor: And Texas.

Mr. Raymond: As a result of this, there was an industry group primarily led by Steve Smith of First Colony and Armand de Palo of Guardian that put together a proposal which was presented to the NAIC a couple of weeks ago. The proposal offers a revised XXX which, among other things, eliminates the exclusion from considering guarantees that are less than five years, provides for a wider range of select factors and a longer term for those select factors (the select factors will be determined by actuarial judgment based on the appropriateness and the specific situation), and allows for a gross premium valuation floor on the reserve, specifically for the term insurance block.

A number of concerns were raised by the regulators when this was presented. Some of the concerns centered on the amount of judgment and how the actuary determines the select factors to be used. The form and content of the actuary's opinion will be specific to the appropriateness of that mortality table. In effect, there was a provision that said the premiums used would not necessarily be the guaranteed premiums in the contract. You could use, however, the premiums that were utilized in policy illustrations for determining the reserves. That also raised a number of concerns.

The actuarial task force accepted the comments that were made, but they've asked the group to go back and flesh out all the details of the proposal to give them something that they can actively deal with because there are still many questions remaining. The group that presented the proposal admitted that there were some issues regarding potential impact on tax and other products that needed to be examined. The task force told them that they would consider reopening the issue if they got a clear proposal, and I believe the group is working toward that goal. If this is going to go anywhere, there must be some strong company support behind it because, as I said, the XXX was developed after a long period of time.

I don't have much to say about codification. We have an effective date, so far, of 2001. There are two issues that I keep hearing about. One is whether there will have to be any active state adoption. I believe the ACLI has been fighting this issue to try to make sure that for codification to become effective in a state, there would have to be an action taken by the state. The original plan of the NAIC was that the codification would basically replace the current practices and procedures manual and subsequently become effective in all states. The ACLI is pushing aggressively to make it something different so that there would have to be an active decision by the states to adopt it.

There have been a set of interrogatories on reinsurance issues that have been floating around for a few years. I think at one time it was Guideline JJJ, which was never adopted but remains on the back burner. The interrogatories are basically interpretations of the model regulation for taking reserve credit for reinsurance primarily defining transfer of risk within the reinsurance contracts. Those Q & As have been a bit of a thorn in the side of many people. They were very controversial at the time when the LHATF was adopting it, which is why they never actually went into effect. They were at one point included in codification as part of the agreement, but to move codification forward they were dropped out. That remains an issue. There is a joint group of regulators and industry people who are trying to figure out what to do with those Q&As.

Bud Friedstat asked me how much I was going to describe Guidelines 33 and 34. I said, "Well, I'll do it in depth. That'll take about two hours." For those of you who don't know, Guideline 33 is the clarification of the Commissioner's Annuity Reserve Valuation Method (CARVM), and tells what to do with multiple benefit streams under CARVM. Guideline 33 came out a couple of years ago. The intent was to clarify how to calculate CARVM, particularly in situations where you had multiple benefit streams. It deals with the question of how do I interpret the question of greatest present value? What does that really mean? Does that mean I have to look at all the different possibilities for potential benefit streams? And how do I integrate benefit streams?

Guideline 33 was intended to clarify that. However, it probably resulted in more questions than it did clarifications. It was revised and adopted last year. It will be effective at the end of 1998. It tells what the greatest present value means, and it tells the idea of an integrated benefit stream where you're looking at the different possibilities of benefits under a policy and determining a true greatest present value of each potential integrated benefit stream.

Guideline 34 was a related guideline that was a specific interpretation of an instance when you have a variable annuity product that has a guaranteed minimum death benefit. Essentially what Guideline 34 said was that you should calculate an integrated reserve using the concepts of Guideline 33 to calculate a total reserve, which should include the minimum death benefit provisions. Then for presentation purposes, you split that reserve out between a general account and a separate account reserve. That's also effective at the end of 1998. There is a provision for a three-year phase-in of any impact to these guidelines for which you will need your commissioner's approval. The New York Regulation 151 comment is that New York is working on their Regulation 151, which is essentially their update to the annuity and their version of CARVM. New York is considering bringing in both the Guideline 33 and the Guideline 34 concepts into that final regulation.

Equity-indexed products. This is a great example of what I think is going on at the regulatory level. The current structure we have in regulations for nonforfeiture valuation doesn't adapt well to new things, if you haven't already figured that out. It shouldn't be a big surprise to you. It's not a flexible system. When we come up with a new product it's very difficult to figure out how it fits in with the present structure. It has also been very difficult for the regulators to keep up with what's going on in the industry. When equity-indexed products started, the regulators at the NAIC were very anxious to understand these products. They did not want to discourage them from being sold, but they did want to make sure they could regulate them appropriately. They turned to the Academy and asked for some education. The Academy undertook a massive effort and put together a lengthy report explaining the product, how it worked, a number of different variations that were out there, and the valuation and nonforfeiture issues surrounding the product, as well as disclosure issues, and some nonactuarial issues like SEC issues. The intent was to educate the regulators as much as possible. It was received well.

As a result of that, there was a guideline for reserving developed in 1997 by Larry Gorski, Guideline ZZZ, which was recommended the same year and is still out there as a proposal. It would clarify how to reserve for equity-indexed products. There were a couple of changes made to that proposal during the last NAIC meeting. One of them was to add an additional reserve methodology. Please don't ask me to explain it, but there was the addition of the Black-Scholes method. Somebody should know what that means. There also continues to be discussion about standard nonforfeiture law, and the implications of this type of product. There are still many questions on exactly how this product fits into standard nonforfeiture law. As a by-product of talking about equity-indexed annuities, there has also been much discussion about equity-indexed life. There was more educational discussion on that at the last NAIC meeting. Actually, Larry Gorski also presented Guideline ZZZZ, which was a revised version of ZZZ to be applied to equity-indexed life insurance.

The regulatory environment can keep up with what's going on and react to and understand new products. Variable annuity/guaranteed living benefits. These are types of things where additional benefits are added to variable annuities such as guaranteeing certain annuitization values. There's a wide range of products out there that guarantee that your premium, accumulated at some interest rate, will be the minimum amount that's available when you reach maturity, or at any point in time. There are also products that reset and allow you, at a minimum, to take your greatest account value and use that to apply to annuitization.

Last year, the Academy undertook a project similar to the one that was done on equity-indexed products to educate the regulators on variable annuity guaranteed living benefits. They presented a detailed report two weeks ago at the LHATF. I had nothing to do with it, but it does originate from a group that reports to me, and puts a lot of energy into their work. The biggest issues are when you hatch these types of benefits onto the contract. Does it still qualify under the valuation law and the standard nonforfeiture law? Does it still qualify as a variable contract? If it doesn't qualify as a variable contract, what is it? You get into some pretty gray areas when you start reading the laws. The recommendation from the Academy is that it still qualifies as a variable annuity contract, and that you then follow through with nonforfeiture and valuation interpretations based on the assumption that this is still a variable annuity contract. Essentially, the reserving recommendation is that a similar methodology to Guideline 34 should be followed, using an integrated benefits approach. That's really an expansion of what's in Guideline 34.

One other issue with that is that in the current version of Guideline ZZZ, the reserve methodologies were not developed with this type of product in mind, but Guideline ZZZ does say you have to use those reserve methodologies for a variable annuity product that has these benefits. I'm not quite sure what that means, but Larry has expressed a willingness to reconsider that if a reasonable recommendation can be made about how to reserve for these products.

Innovative products. This is just a structural issue at the NAIC. These are the types of things that the regulators keep seeing. Their frequent question is how should they deal with these products? One of the comments we've heard from them is that every couple of months they see something new coming out from the industry, and they're trying to figure out how to keep up with that and how they can do that within their structure. The LHATF established a subgroup that meets each quarter that is specifically geared toward looking at innovative products. They subgroup meetings offer a place where they can try to be educated, from their point of view, and also be as responsive as possible to what's going on within the industry. The equity-indexed products and these variable annuity benefits are the types of things that, at least initially, have been discussed. They have a few other things too.

Separate accounts with guarantees. There is an NAIC model that is essentially an expansion that is very similar to Regulation 128 which is working through the process at the NAIC and expanding that to apply to all separate account products with guarantees. There is a parallel version to that to also apply that New York Regulation 128-type methodology to synthetic GICs. The LHATF approved the reserve provisions of those two models at their meeting two weeks ago. It does require an actuarial opinion on the reserves within the separate accounts for these products. Again, it more or less follows the Regulation 128 rules.

My last topic, separate account installation, is a very important issue to me. There was a Minnesota bulletin that came out about six months ago that raised the question of whether it's appropriate to insulate separate account assets. Can you wall off a separate account and say that these assets are only available to separate account policyholders? To what extent can you do that? It's becoming more and more an issue as separate accounts expand, more guarantees are put into separate accounts, and more guarantees are made from the general account to the separate account. More and more companies are guaranteeing that their separate account policyholders will be treated better than their general account policyholders. The separate account policyholders will get first call, and they will make sure of that. Minnesota basically came out with a bulletin that said, "No, you can't do this in

Minnesota." They can argue the law to say it says that. They feel strongly it does. This is an issue that is being looked at on various levels at the NAIC and in various states. Separate account models allow you to do it in general. You just have to clarify it. New York Regulation 128, when you put guarantees in one of these separate accounts, allows you to insulate up to the level to protect the policyholders' assets from general account liabilities. The policyholder is taking all the investment risk. Policyholders' funds and the investment performance of those funds passes through to the policyholder. You can protect those assets from general account liabilities. Any additional guarantee you make from the general account cannot be protected. That's what New York Regulation 128 says. But if you look at the models in general, you can go further than that. This will continue to be an issue as to how far you should be allowed to go and what is appropriate.

Mr. Herget: I'd like to introduce Bud Friedstat. Bud joined the Chicago office of KPMG Peat Marwick in 1993. Prior to that he was with another major professional service firm and a large stock company as well. Bud is currently the chair of the Valuation Actuary Symposium Planning Committee. He is the associate editor of *The North American Actuarial Journal,* a past member of the Society's Financial Reporting Section Council, and a board member of the Insurance Tax Conference.

Mr. Charles D. (Bud) Friedstat: I'm going to quickly go through four areas, and talk about the tax effects on them. I want to first talk about the applicable federal interest rate (AFIR), give you an idea of what it's about, and tell you how it might affect some of your taxes issues and certain tax planning opportunities. I want to go through many of the things that Craig talked about, and talk about the tax implications of those. I want to briefly discuss a few recent cases and rulings that will be of interest from a tax point of view and also talk about a few product tax issues.

I want to talk a little bit about the AFIR, what its prospects are and how it's determined, and give you a better idea of just how it might affect some of your product pricing and some of the taxation through the area of tax reserves. Table 1 shows you how to determine the applicable federal interest rate. For years 1988 onward your tax reserves—the valuation interest rate for tax reserve purposes—are based upon the greater of the applicable federal rate and the so-called state prevailing rate or the dynamic valuation interest rates that we're all familiar with. What Table 1 does is show you how the AFIR is determined. It's basically a rolling average of 60 months of the so-called applicable federal midterm rates, published monthly by the Treasury. If you think about it, it takes a long time when you're averaging five years' worth of rates to get the impact currently compared to the state prevailing rate, which is reflective that's pretty prevalent of conditions in the last 12–18 months.

Table 1 shows a list of rates. I want to show you how the rate for the year 1998 came into play. That rate has been determined. It's 6.31%, and that was reaffirmed in Revenue Ruling 98–2. That rate is the average of the 60 rates from 1993 through 1997. What are the prospects for the 1999 rate? We won't know that for sure until the end of 1998, but in essence, the numbers in my 1998 column will be substituted for the numbers in my 1993 column. We used a very complicated actuarial projection method to project the interest rates for the remainder of the year. We straight-lined the rate for May and assumed it would remain unchanged. If you look at the number at the bottom, the average of those rates is about 5.7% for 1998, whereas it's replacing an average year of 5.49%. If those conditions are true, we'll come up with a rate of about 6.35% as the AFIR for 1999. If you look at this historically, we're at a bottom point. It has been leveling out over the last three years.

TABLE 1
DISCOUNTED UNPAID LOSS CALCULATION
SECTION 1274 FACTPRS

Month	1991	1992	1993	1994	1995	1996	1997	1998
January	8.12%	6.73%	6.34%	5.32%	7.92%	5.73%	6.10%	5.93%
February	8.00	6.35	6.22	5.34	7.96	5.61	6.38	5.69
March	7.82	6.69	5.88	5.36	7.75	5.45	6.42	5.59
April	7.88	7.00	5.45	5.88	7.34	5.88	6.49	5.70
May	7.98	7.10	5.46	6.43	7.12	6.36	6.85	5.69
June	7.91	7.04	5.33	6.92	6.83	6.58	6.80	5.69*
July	8.02	6.85	5.54	6.83	6.28	6.74	6.65	5.69*
August	8.19	6.49	5.32	7.05	6.04	6.84	6.39	5.69*
September	7.96	5.98	5.35	7.05	6.38	6.64	6.23	5.69*
October	7.54	5.78	5.00	7.10	6.31	6.72	6.34	5.69*
November	7.22	5.68	4.92	7.45	6.11	6.60	6.10	5.69*
December	7.07	6.15	5.07	7.74	5.91	6.31	6.02	5.69*
	7.81%	6.49%	5.49%	6.54%	6.83%	6.29%	6.40%	5.70%
APPLICABLE FACTORS FOR DISCOUNTED UNPAID LOSSES								
				Year 1995	Year 1996	Year 1997	Year 1998	Year 1999
				6.99%	6.63%	6.33%	6.31%	6.35%

*Note: Estimate only. Actual percentage is yet to be published.

Table 2 gives a little bit more history on this and shows how it applies to certain products. This is really important to the product development actuaries. About six years ago the product development actuaries had some problems, and there were many complaints about pricing these products. The tax reserve is so much lower than the reserve that I have to set up because of the spread between the applicable federal interest rate that you have to use for tax purposes and the state prevailing rate. Table 2 shows the difference and the spread for three types of products: a whole life product, a deferred annuity, and a single premium immediate annuity (SPIA). One of the primary tax planning items in the reserve area is to minimize the difference between books and tax reserves, but here's what they were excited about. If you look at whole life as an example, you'll see that the maximum difference between the AFIR and the state prevailing rate occurred in 1993. In fact that was true for all three products. But that maxed out for life products at about 3.1%. With each new year, the difference drops and bottoms out at about 1.81%.

TABLE 2
RELATIONSHIP OF FEDERALLY PRESCRIBED RATES
TO STATE PREVAILING RATES

Issue Year	Whole Life			Deferred		SPIA	
	AFIR	SPR	Excess	Ann. SPR*	Excess	SPR	Excess
1988	7.77%	5.50%	2.27%	6.75	1.02%	8.75%	0.00%
1989	8.16	5.50	2.66	6.50	1.66	8.75	0.00
1990	8.37	5.50	2.87	6.25	2.12	8.25	0.12
1991	8.42	5.50	2.92	6.25	2.17	8.25	0.17
1992	8.40	5.50	2.90	6.00	2.40	7.75	0.65
1993	8.10	5.00	3.10	5.50	2.60	7.00	1.10
1994	7.45	5.00	2.45	5.25	2.20	6.50	0.95
1995	6.99	4.50	2.49	5.75	1.24	7.25	0.00
1996	6.63	4.50	2.13	5.25	1.38	6.75	0.00
1997	6.33	4.50	1.83	5.25	1.08	6.75	0.00
1998	6.31	4.50	1.81	?		?	
1999	?	?					

*Plan type c with cash settlement options, future interest guarantees, and a guarantee duration of five years or less.

We know what the rate is for 1998. We don't know what the excess will be for annuities for 1998 because that hasn't been finalized. We can estimate what it will be, but it won't be determined and announced until the end of June 1998. The same applies for SPIAs. The key thing to get from Table 2 is that the maximum difference between the AFIR and the state-prevailing rate has bottomed out. There is one thing that I do want to emphasize on SPIAs. You often hear people say the tax valuation rate is the Applicable Federal Rate (AFR), but it is truly the greater of the AFIR and the state prevailing rate, and don't overlook the fact that for the last three years and possibly for this year the governing rate for statistical tax purposes has been the state prevailing rate. It has actually exceeded the AFIR in the last three years. Of course, at the end of this month, we'll know what the finalized rates will be.

The reason I want to talk about five-year election because there is a provision in the code that allows you to elect to revalue your tax valuation interest rate and to substitute the current AFIR for the AFIR in policies issued five years ago. For example, if in 1997 we decided we did some prudent analysis and wanted to make this election, in 1997 we would elect to revalue our 1992 policies at the current applicable federal interest rate, and since the AFIR has dropped, that would give us a substantial benefit. The way this thing works, though, is that once you make the election, it is irrevocable. You are locked into it. For instance, in 1998 you'd have to revalue 1993 contracts. If interest rates were to rise, you would be stuck with having lower reserves. Unlike the Section 807(f) change in reserve method, the entire change in reserve, whether it's an increase or a decrease, will go through taxable income in the same year. There is a potential upside and downside risk, so companies have been reluctant to roll the dice and make this election. However, I am aware of at least two companies that have made this election. If you are considering it, you should do a detailed analysis. You should look at the situation and be very confident that the potential benefit to you is far more substantial than the downside. That's what most companies have done. It works well with products where the cash-value floor minimizes the downside risk, and there is a potential upside risk if interest rates drop. Actually, there's one other key factor that you probably won't see written in terms of companies and why they would make this election, and this is true for the two companies that I'm aware of.

You are much more likely to do this because it's a no-brainer. You will have tremendous benefits this year and probably the next couple of years. What everybody's afraid of is what will happen down the road. The person who has about 10–15 more years from retirement is looking at the increase in interest rates and the explanation that the entire decrease in reserves would flow through income at one time.

I want to briefly go through a number of NAIC issues and some tax implications. As Tom mentioned, there will be time for more detailed questions, if you have any, on these areas. Actuarial Guideline 33 is a clarification, and it's not dealt with a new interpretation of CARVM unlike the 1995 version where there may have been some questions. This is truly a clarification. It's supposed to define and clarify CARVM for how it is supposed to work with multiple benefit streams. It gets into the concept of elective and nonelective benefits, but it's truly a clarification. In accordance with Section 807(f), any change in reserve that happens as a result of this will flow through income over 10 years beginning the year after the change.

Guideline 34 has some other interesting issues. Like Guideline 33, Guideline 34 was passed by the NAIC in 1997, made effective in 1998, and there is a three-year spread. In addition to the issue that I'm going to talk about, there's one particular issue related to Guideline 34 that ties in with some past tax reserve issues. As Craig mentioned, the reserve is initially calculated based on a total reserve concept, including the minimum death benefit guarantee. You then calculate the reserve in accordance with the same principles without the minimum death benefit guarantee, and you put that reserve in the separate account. The so-called minimum death benefit guarantee reserve winds up in the general account; that's really the tax issue—how do you treat this for tax purposes? The only existing guidance on this is a ruling under the 1959 act that was related to John Hancock, and that wasn't entirely on point. It dealt with whether the additional minimum death benefit guarantee reserve qualified as a life insurance reserve for tax purposes. That was an unfavorable situation. The ACLI 807 Task Force produced some relevant discussion papers many years ago, and while they aren't binding, they do give you some of the arguments and support for the different positions. Basically, how are you going to treat the minimum death benefit guarantee reserve? Are you going to calculate it separately? Do you have to aggregate it with the base policy reserves in the separate account? Is it deductible at all? There are many issues that are in that vein.

One thing I wanted to mention before addressing Guidelines 33 and 34. A method becomes effective for tax purposes when it's approved by the NAIC, unlike the 26 states required for mortality table and interest rate. This was approved by the NAIC in 1997. It does not have to be adopted by anybody until 1998. There are at least some companies that are considering taking this position that for tax purposes it was effective in 1997.

Equity-indexed products. Again, this is an interpretation of how CARVM was supposed to apply to a product for which it wasn't entirely designed. I won't get into the reserving. There was a session (59PD Equity-Indexed Products: Now That You Have Them, What Are You Going to Do with Them?) that went into that in far more detail. I do want to talk about the considerations that were part of the Academy Task Force tax subgroup that I chaired, that watched over things to make sure that there weren't any unforeseen tax problems. That was part of the December 1997 report. It's a very short task force report. It deals with reserve issues and nonreserve issues. We were very careful to describe certain things in general terms. We did not want to give a blueprint to the IRS about potential tax planning opportunities and tell them where to look in case there were some companies doing this.

On the reserve side we are very careful to keep things in accordance so that there would not be a tax problem. It was very important both from the valuation point of view and the tax point of view that these methods that were adopted be consistent with CARVM principles, and that they calculate reserves in relation to greatest present value of future benefits. Consistency with CARVM principles was important for tax. Without getting into it again, there are three possible alternative methods, possibly four if you consider Black Scholes. There was some concern that the IRS might look at this as allowing different methods. This might be some way of manipulating results for larger tax deductions. We tried to make it very clear that these methods yielded essentially the same results; that there were alternate methods for ease of administration and calculation procedures, and it was very important both from a valuation point of view and a tax point of view that there were no holes in those methods.

From a tax point of view, as I mentioned, this is not effective for tax purposes until it's adopted by the NAIC. Prior to adoption by the NAIC, you were supposed to use the prevailing view of the states. There's no prevailing view of the states unless you consider Illinois' view of the prevailing view of the states. Thus, some issues remain. From a practical point of view, people are going to start by looking at what they did for statutory purposes, but there are some opportunities open in terms of how you reserve for equity-indexed products for tax purposes for 1997 and prior issues.

Regulation XXX. Who knows what the potential reopening of this will do for taxes going forward. Even though it has not been adopted by 51% of the population of the states, it is effective for tax purposes. It was effective in 1996. It became effective for tax when it was adopted by the NAIC. This is still the tax reserve method, even if it doesn't get approved for another five years.

Prospects for annuity and disability tables. That was one thing that Craig did not discuss. The Annuity 2000 table and the comparable table on the group side are under review. There have been, as I understand, less than ten states that have passed it, so it's unlikely to be implemented by 26 states prior to 1999. When that does happen that becomes the prevailing state table for tax purposes, whether it has been adopted by your home state or not. I'm sure that the ACLI and other groups will be keeping track of that. Even if you haven't adopted for statutory purposes, that will yield significantly higher reserves for your income-paying annuities because of the improvements in mortality.

There has been an SOA group that was asked to look at the possibility of developing new disability income tables for individual disability income contracts, as well as group disability income contracts. Why is this significant? In general, states don't adopt disability tables. Twenty-six states have not adopted disability tables. So how do we know what tables to use for tax purposes? For individual disability contracts that do meet the definition of life insurance reserve there was TD8278, which basically gives a list of the mortality and morbidity tables to be used where there are no federally prescribed tables. Currently for contracts issued after 1988, and for claims incurred after 1988, the 1985 Commissioners Individual Disability Table A (CIDA) and Commissioners Individual Disability Table B (CIDB) are the tables that you are supposed to use. For group, you're supposed to use a table that's reflective of your own experience. From a practical point of view most people use the 1987 table for statutory purposes with some modification of determination rates. It's hard to argue that that isn't representative of your own experience, so most companies use that same table and change the interest rate to value reserves for tax purposes. Once that group table becomes effective, it is very likely that you will then transfer over to that for statutory. It may very well affect what you'll hold for tax purposes.

Taxes are also a consideration for the NAIC Valuation Task Force. There are many task forces. The Tax Task Force was chaired by Ed Robbins, and it has made the committee aware of certain things that need to be understood and considered when looking at these possible new valuation approaches. It was deemed very important that you maintain the relationship of statutory reserves and tax reserves. If we do take a white piece of paper, realize that historically it has been a very close relationship and that any fundamental change in statutory reserves would have to require that the tax law be rewritten. Surprise! It probably would lead to an increase in taxes for the already heavily taxed life insurance industry.

One of the other issues that really ought to be watched is having reserves that might be less than the cash value. Currently that might be acceptable under GAAP, and the fact that there is a cash value floor on reserves for tax purposes is another important consideration. With the 1984 Tax Act, one of the motivating factors was to make sure that companies that wrote similar products held the same level of reserves, and that one of the possibilities would be that companies writing similar products under this new Valuation Task Force would be given certain latitude, and the companies would be holding different reserves for statutory. That is also a concern.

I want to make you aware of a couple of other developments. Notice 9732 from the IRS basically dealt with certain interim rules for modified guaranteed contracts (MGCs). There had been certain deficiencies in the tax law that treated modified guaranteed annuity contracts unfairly in certain situations. Internal Revenue Code Section 817(a), for all practical purposes, eliminated that unfairness. Notice 9732 relates to contracts that do fall under 817(a) that are not separate contracts for tax purposes. They're interim rules that relate to what interest rate you should use for tax purposes under certain situations. There could be a higher interest rate than the normal rate you use. At one time they were asking for comments about whether this regulation should apply to equity-indexed annuity (EIA) contracts, and it's fairly obvious now that unless your EIA contract does fall under this modified guaranteed contract (MGC) classification, it won't apply. However, if you do have an EIA contract that is a registered separate account contract. It may very well fall into this but, as of now, there are only a couple of companies that have that product.

I want you to be aware of Pacific Corinthian, not because it's an important case—it may not go any further—but because there are some issues from a tax point of view that would apply to other situations. The case relates to Pacific Life's acquisition of First Capital, and, as you know, in that situation, there was a restructuring of the contracts, which generates a number of potentially interesting issues. The IRS basically took a very negative position. There's a lot of money involved, and this may very well be settled out of court, but looking at some of the documents, there's some very interesting issues in terms of the contract restructuring, and how you apply CARVM and Actuarial Guideline 33 to contracts that have been restructured in that manner. Do you get the change in the reserve all in one year or is it an 807(f) ten-year spread event? They also had an inconsistent treatment in terms of the adjustment of reserves between the opening and the closing balances.

The IRS's position on 807(f) has changed in the reserve computation process. Almost everything is a change in method, which would require a ten-year spread, including if you use the wrong interest rate. You would think that's a correction of error. In fact, it's a change in method. You get an immediate change for a correction of mathematical or posting error or there is a ruling that basically if you forgot to value a certain benefit associated with the policy, you get to pick that up, but almost everything else is a ten-year spread event.

In terms of IRS audit issues, the IRS is getting more sophisticated. They're asking seemingly more intelligent questions, and they appear to have gotten hold of a copy of the Tullis and Polkinghorn book. This is the truth. While I was assisting a client with a reserve audit, the IRS agent actually asked the company, "Are you on the California method for universal life?" I thought that was an astute question for an IRS agent. Basically the California method takes the mean of the cash value and the account value in certain situations. There also seems to be more of a focus on separate accounts and separate account reserving as well as some tax planning opportunities in relation to the dividends-received deduction, which I don't want to get into too much.

With several recent cases that involve mutual companies, the IRS seems to be arguing out of both sides of its mouth. A few years ago Pan American had a case in which they argued that although they were chartered as a mutual company, they really operated as a stock company, and they should be treated as a stock company for tax purposes; therefore, they wouldn't be subject to the differential earnings rate and the so-called equity tax. The IRS said, "No, you are what you are for state purposes," following a consistent tradition of giving substantial credence to statutory accounting and state purposes.

Enter Pacific Life. Pacific Life set up a mutual holding company, and the membership rights were transferred as normal to the mutual holding company. The stock subsidiary had all of the benefits and the policies, and it was a stock insurance company for state purposes. The IRS didn't look at the form. They looked at the substance. They said you aren't doing anything differently from what you did before. Your guarantees to the policyholders and your reflection of experience haven't changed. You're still a mutual company for tax purposes. This inconsistency will have to be addressed, and I would look for some development in that area.

There is an ACLI resource paper that has been developed on 7702 A material changes, so-called Max. I don't know if that has been distributed through the ACLI yet. It was near finalization, and if it hasn't been distributed, it will be distributed shortly. It doesn't give direct answers—there are a lot of gray areas—but it does give the arguments, pro and con, and I think it'll help you establish your own position in terms of how to handle those issues.

IRS settlement procedures. As for 7702, the IRS has been reasonable for a number of years if you go in and confess your sins. They will not be happy with you if you bought a vendor system and found out that the vendor system did not operate the way it should. It's your obligation to check that out, and the IRS is not sympathetic in those situations. In situations where you're operating your own home-grown system that involves a person to intervene at a certain point in time and that person makes a mistake, the IRS has been fairly sympathetic as far as settlement programs. The other thing that's going on is that the IRS has had a MEC corrections program that would adopt similar procedures for violations of 7702 Cap A. We understand that the IRS is fairly close to coming up with a position on that. There are some hangups in relation to certain variable annuity contracts.

The last thing I wanted to mention was a ruling that is relevant in the product area. It's the third in a series of rulings that deals with treatment of so-called term-on-the-insured where you have a base policy and a term rider on the base insured. That ruling is 9741046.

Mr. Herget: Next I'd like to introduce Frank Buck who will address GAAP issues. Frank qualified as an actuary in the U.K. before moving to the U.S. via Canada. He has worked for both mutual and stock companies and as a consultant. He is currently a partner with the accounting firm Deloitte & Touche, and in addition to his responsibilities for the National Life Actuarial Practice, he has recently been asked to assist with Deloitte & Touche's global expansion of their actuarial practice. Frank was recently chair of the Financial Reporting Section Council and was part of the faculty for the first three GAAP seminars sponsored by the SOA. He is currently a member of the Life Committee of the Actuarial Standards Board (ASB).

Mr. Frank J. Buck: I'm going to talk about GAAP and GAAP development. There's a new life and health guide coming out. I'll also discuss a paper on present values, as well as other developments in deposit accounting, nontraditional contracts, and international developments. In fact, when Tom asked me to do this I thought that having been involved with accounting firms for a number of years and having given a number of GAAP seminars, would make this easy. I must have given dozens of seminars to clients, the SOA, and other groups. Then it occurred to me that the stock company guide came out in 1972. Interest-sensitive products dealt with by *Financial Accounting Standard (FAS) No. 97* came out in 1987. The mutuals had their go about three years ago with *FAS No. 120*. We've covered reinsurance. We've covered deferred taxes. What's going on? What is there? There are quite a lot of things going on right now in the world of GAAP.

Back in 1972, the guide to stock life insurance companies came out. That was replaced by *FAS No. 60* about 10 years later. Essentially, there was no difference between the stock life guide and *FAS No.60*. Much has happened since that time. We've had developments in interest-sensitive products and mutual companies, and many different types of contracts have come out since then. The Insurance Companies Committee of the AICPA decided it was time to review their guide and issue a new one. The guide itself was presented to the Accounting Standards Executive Committee in the first quarter of 1998, and it was approved unanimously. It has now gone to the FASB to be issued.

A number of things that actually require the use of an actuary in an audit are probably mandatory going forward, and the various accounting firms have used actuaries in different ways. They've used actuaries in many different ways over the years, and different companies have developed the use of actuaries in audits in different ways. In fact when my firm merged back in 1989, on the Deloitte side there was a requirement that they use an actuary for property and casualty (P&C) audits but not for life audits. On the Touche side there was a requirement that you had to use actuaries for life audits, not for P&C orders. Somehow we managed to get together. Although the other accounting firms have had different requirements for the use of actuaries, their involvement in advising our auditors when they're looking at the audits of the companies has increased dramatically over the years. The new guide incorporates many of the standards of practice and practice bulletins and is expected to be passed and be effective after December 1998.

It will incorporate a tremendous amount of material. Even as long ago as August 1978, there was an SOP on the confirmation of insurance policies in force. There's some reinsurance information going back to 1984 to include the Mutuals, GAAP Mutuals, risk-based capital (RBC), surplus notes, and whatever the auditors go through these days.

Accountants are just beginning to understand present value. At least they think they are. There has been a task force, a project overseen by the accounting profession since 1988, looking at present value and how you deal with present value. It may seem strange to you that they've been studying present value for ten years (it certainly does to me), but there was a discussion that came out in 1990. There was a special report that came out in February 1996, and there's an exposure draft that came out about a year ago. Actually, that document is called "Using Cash-Flow Information In Accounting Statements." The accountants have just begun to realize that there's a difference between $1,000 dollars payable to them and $1,000 payable in ten years time. They've also begun to realize there's a difference between a risk-free $1,000 amount and a riskier $1,000 dollars. They're beginning to bring this in and are wondering how to incorporate it, so there's this wonderful draft.

This draft, what they call a statement of finance and accounting concepts, is not a FASB pronouncement but accounting concepts that are supposed to help the FASB in coming up with whatever decisions they make. It doesn't have the power of an actual pronouncement. It's just a concept. Nevertheless, they have decided that it will deal with measurement issues only. It will not deal with the recognition. It will not tell you when you have to revalue something on a present value basis, but it will tell you how to proceed. It's going to be based on risk-adjusted market value and risk-adjusted entity specific measurements. What is it going to do? All sorts of things. When going through all of this, it suddenly occurred to me that the accounting profession should have been doing what we've been saying for the last five years—ask an actuary.

Deposit accounting. When *FAS No.No.113* came out—that is the statement that deals with reinsurance—it determined what you should do when there was risk transfer in a reinsurance contract and how you accounted for it. It also went through and gave some criteria for determining how you knew whether there was risk transfer or not. I'm not going to get into the complications of just how clear that guidance was and how it has been applied in practice, but clearly there's the case that someone decides that transfer of risk has not taken place, and you have to account for what you have left. Deposit accounting is the treatment that's proposed.

There's a draft statement and position, and it deals with four different situations. There are four types of contracts involved that you need to cover. You need to cover insurance and reinsurance contracts where there's no timing or underwriting risk, those where there's only a timing risk, those where there's only an underwriting risk, and those where the risk is indeterminate. Regarding the proposed treatment for the first two, if there's no timing or underwriting risk or if there's just a timing risk, you should use *FAS No.91,* the same sort of treatment that you would use for annuities without life contingencies, structured settlement annuities, or something like that. If there's an underwriting risk, it gets more complicated. Until the loss occurs you measure the deposit by the unexpired portion of coverage. When the loss does occur use the present value of future cash flows plus the unexpired portion of coverage. The last one, indeterminate risk, gets even more complicated. When you cannot determine what the risk is, you should be using SOP 92–5.

As with other areas, nontraditional contracts need to be looked at as well. Since the various accounting standards have been developed, many new contracts have come out, such as with equity-indexed products. The AICPA is now considering nontraditional contracts, and there will be a draft SOP coming out sometime soon. In February 1998 the FASB cleared the way for a draft SOP to cover valuation of liabilities, which is not surprising, the classification and valuation of assets, whether they're general account assets or separate account assets, amortization of deferred acquisition costs, and a number of other disclosures.

The current products are all handled somehow or other under the various accounting treatments, but clearly a lot of guidance is needed in many areas, and it's very difficult to fit some of these new contracts into the existing FASBs. They need special guidance variable annuity contracts where there's a guaranteed return of principal or there's a guaranteed return of principal with a minimum stated interest rate, fixed annuities with guaranteed minimum rates, plus a contingent return, which is more like the equity-indexed annuities where the contingent return is linked to the Standard & Poor's 500 or something similar.

Market-value-adjusted contracts, fixed annuities. We've provided a teaser rate for the first year, and a bonus rate at some point in the future. That's not always handled that well under the existing methodologies. Last, variable annuity contracts that offer minimum death benefit guarantees contingent upon underlying performances. These are some of the areas that are being handled.

International accounting standards. About three years ago the Technical Committee of the International Organization of Securities Commissions made an agreement with the International Accounting Standards Committee (IASC) to endorse global accounting standards for the purposes of cross-border offerings and listings on all the global capital markets. The SEC is a member of the International Organization of Securities Commissions and will, therefore, have to decide whether it's going to adopt the standards for foreign private issuers. In December 1997 a steering committee was set up to review what needs to be done in the international area, and that committee has been collecting data that will be reviewed at a meeting this month.

In November 1997, there was a discussion paper on international financial statements. Don't forget that financial statements are providing information about the current financial position, changing financial position, and performance. It has to be stated in a way that's useful to the users of those financial statements. The only way it can be useful is if the financial information is understandable, if it's relevant, if it's reliable, and if you can compare it from one company to another. The key is measuring assets and liabilities for the international standards. How do you recognize profit? How do you recognize income?

There are so many different approaches throughout the world, that trying to get some sort of standard is difficult. Simple things like the profit-and-loss (P&L) statement in some countries is one consolidated statement. In others it can be split between life business, nonlife business, and other business, and you don't know exactly where you are when you're looking at it. I know from my own personal experience of having to account under U.S. GAAP for foreign contracts it's very difficult to fit them into U.S. GAAP in many instances. Thus, it's not easy to have an international standard. The discussion paper talks in terms of A/L, etc. How do you recognize assets? A preponderance seems to be going toward a fair value approach to the recognition of assets. What do you do with gains and losses? Do you pull them straight to the bottom line as we do under U.S. GAAP or do you amortize them over time? I think international standards papers are moving toward recognizing them immediately, but that's not always so easy. How do you value the assets? There are different approaches to valuing assets. Under U.S. GAAP you have three different standards—held to maturity, available for sale, and trading—and the valuation of assets under those three standards is different.

Under the liabilities the key is recognizing profits on the business. In the U.S. alone we have three different standards. The profit recognition is different under all three, and obviously the keys to that are how you define and defer acquisition costs. How do you amortize them? How conservative are the assumptions you're using? Does the policyholder participate in the surplus, in addition to the earnings from the participating business? It's a complicated issue.

The IASC has approved a few statements, and I want to go through these in about ten seconds because we run out of Q&A time. Interim financial reporting is fairly standard. It says that you should report on an interim basis similar to how you did it last year.

Employee benefits. There is a standard that has been approved, and they have the assets at fair value. You have the pension liabilities at market value. The discount rate is using high quality corporate. They're moving toward fair value or market value in most of these standards. There are some tentative decisions for financial A/Ls. Once again you have an initial valuation at fair value, and subsequent asset valuation mainly at fair value, though there could be some differences. The same sort of trend goes through the international area.

Mr. Lance E. Schulz: Bud, could you go through what the rulings are on the basic term riders for 7702?

Mr. Friedstat: Sure. The first ruling, number 9106050, involved a base policy with a five-year term rider. The whole issue is how you treat the two together and what goes into the death benefit and the issue. Number 9106050 basically had a base policy with a five-year term rider. You basically wind up getting qualified. The Qualified Additional Benefits (QAB) treatment for that is not going to death benefit. There was a 1995 ruling, 9519023. The situation there dealt with how you treat it for 7702 Cap A, and the rider was greater than seven years, which is significant. The result of that ruling was that, for 7702 A purposes, you were allowed to treat it as part of death benefits in terms of the MEC calculations. There's ample support for that apparently inconsistent ruling between those two, but there is different legislative history behind that. The 9741046 is very significant. That situation involved a policy that had a term rider. The amount of target death benefit remained the same. If you added the base policy and the rider, it remained the same, and while the amount of rider benefit and base policy benefit might have fluctuated during the period, there was always a constant amount of death benefit. Basically what they said was that as long as the term of the rider was consistent with that of the base policy and extended to at least age 95, it would be treated as death benefits for both 7702 purposes and 7702 Cap A.