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Session 117PD Accounting for Policyholder Dividends

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Summary: This session explores alternative methods for accounting recognition of the costs of policyholder dividends. Currently, several methods are in use in the U.S., with other methods used in the U.K., Canada, and elsewhere around the world. The theoretical bases, as well as the impact on anticipated earnings patterns, are discussed.

Mr. Darryl G. Wagner: I have had the privilege of working with the American Institute of CPA's (AICPA) task force that's been dealing with the issue of accounting in the context of demutualization and mutual holding company reorganizations. And one of the issues central to that is dealing with dividends, particularly where you have a closed-block situation. The committee's work became the foundation or impetus for this session.

Patricia Matson is a consulting actuary with Arthur Andersen in the Hartford office. She's worked extensively in the demutualization area and along with me has assisted in the work that the AICPA task force has been doing. Ken LaSorella is the vice president of U.S. GAAP for SunLife of Canada and in that role he is responsible for all technical actuarial aspects of GAAP for the company worldwide. Prior to that, he was with KPMG, where he worked in areas including GAAP conversions, mergers and acquisitions, and purchase GAAP. Finally, Brian Purves, is the director of PricewaterhouseCoopers' London Actuarial Consulting Practice. In that role he has been involved in most of the major U.K. companies that have listed in the U.S., including Prudential U.K., Royal Sun Alliance, and AXA. He's been with PricewaterhouseCoopers for about five years and before that was with Watson Wyatt, including a brief stint in Germany.

We're going to explore alternative methods for accounting recognition of the costs of policyholder dividends; obviously that can be a very far-reaching topic. We're going to look at that within a couple of contexts. One is focusing primarily on the accounting for dividends under U.S. GAAP. The second is the context of there being some kind of constraint on the dividending process. In the case of demutualization,

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typically, that would be a closed block, at least in the U.S. Brian is going to talk about some of the constraints that exist in the U.K. environment from a regulatory perspective.

Tricia is going to talk about the work that the AICPA task force has done with respect to accounting for demutualizations, what some of the major conclusions from that group have been, and in particular, some actuarial issues surrounding the dividends. Ken is going to pick it up from there and talk about, from a practical perspective, how some of this really works. He's going to go through a couple of pitfalls that you can run into with these kinds of approaches and calculations, and some of the alternatives and solutions. Then Brian is going to take us across the Atlantic and talk about things from a U.K. perspective. Again, we're talking about a different type of constraint, and how the dividend accounting happens there and some of the trends and methods that may link into the work that's happening here with respect to demutualization.

Ms. Patricia E. Matson: I'm going to cover some of the issues that were addressed by the AICPA task force related to accounting subsequent to a demutualization or a mutual insurance holding company (MIHC) conversion.

There are basically two forms of demutualization. The distribution form which is typically used, is when policyholders receive consideration in exchange for giving up their rights in the mutual insurer. The second form is extremely uncommon. Rather than giving stock or cash or compensation of that kind, policyholders receive subscription rights, which enables them to purchase stock in the converted company, if they desire, but it doesn't give them any other consideration. There aren't many states that allow that one so it's very uncommon. In general, we're talking about the distribution form.

The MIHC is an alternative to demutualization. It has gotten some interesting criticism, but is frequently used and a lot of companies have converted to an MIHC. This form of reorganization also does not involve a distribution, but what happens is the insurance company converts to stock form and an MIHC is formed. The policyholders retain their rights in the MIHC so they still are members and owners of that company, which in turn, then owns at least half of the converted stock insurance company. Those are basically the two primary methods of converting: the distribution form of demutualization and the MIHC.

Typically what happens in the case of a demutualization is the creation of a closed block. That mechanism is designed to protect the dividend expectations of policyholders. This is done primarily to address the concern that when you convert from mutual form to stock form, there may be some issues with respect to competing interests of your policyholders versus your shareholders. A lot of state regulations require that if you convert to stock form, you need to set up a closed block, which essentially is a walling off of assets to be used exclusively for the benefit of your participating policyholders. Those assets are not available to your shareholders subsequent to demutualization.

The amount of assets you set aside is such that, going forward, those assets plus the future revenue you receive from your closed-block policyholders is just sufficient to cover the future benefits, future dividends at the current scale, and whatever else maybe considered part of the closed block. You may include taxes and/or some form of expenses in the closed block. The assets are there to cover all the future obligations to your policyholders and can't revert to the benefit of shareholders. That's the crux of the issue with respect to accounting after demutualization.

The assets are expected to be sufficient to cover future obligations. You set up these assets initially using your best-estimate assumptions and the current dividend scale, but going forward, clearly things are not going to happen as you estimate. The experience may be better or worse than the initial expectation; those differentials need to go back to the policyholders through changes in the dividend scale. This is essentially protecting the expectation that exists at the time of demutualization.

The task force developed a statement of position to address accounting for demutualization and MIHC formation. So far the exposure draft has been released. There have been several comment letters. Those have been addressed in a revised draft and the release is expected in the very near future.

First I'm going to briefly cover a few items, noted by the task force that are not specifically related to dividends, and then I will get into some of the details on the reporting of dividends going forward. One thing I'm going to cover has to do with what this transaction represents. Essentially, the task force decided that a demutualization or an MIHC formation does not constitute a change in ownership. The key point is that there's no purchase accounting required in the event of a conversion like this.

The next question the task force addressed was how you treat participating policies after the demutualization, both those sold prior to demutualizing and any you might sell after the conversion. The task force concluded that Standard of Practice (SOP) 95-1 should be applied with one exception. The fact that now there are stockholders involved in the mix after the conversion made them decide that you should recognize a liability for future policyholder dividends. That's consistent with Statement of Financial Accounting Standard (SFAS) 60, Paragraphs 41 and 42, which talk about setting up such a liability.

The next issue that was addressed, and this one took some time, was how to deal with the emergence of earnings in the closed block. As we've talked about, the assets in the closed block are intended to benefit the policyholders and the policyholders only. When the closed block is set up, you have your best-estimate closed-block assets and then you have liabilities that exceed the assets because there is some provision for adverse deviation in the liabilities. That differential is the maximum earnings to shareholders over time—anything else needs to be given back to the policyholders over time.

What happens as of the demutualization? An actuarial calculation is performed that is a projection of future changes in the net closed-block liability, or the difference between the assets and liabilities. This is done as a best estimate. It considers only what's in the closed block so if you don't have expenses in there, it doesn't consider expenses. And it's before the impact of deferred acquisition cost (DAC) amortization. The actuarial calculation date ideally is the date of conversion. However, some of these conversions took place quite a while ago. For example, UNUM doesn't have to go back to the 1980s to try to recreate years of financials. There is an option to do this calculation as of the date of adoption of the new standard.

In this emergence of earnings calculation the accumulated actual earnings that occur over time, that are in excess of what was calculated initially as of the calculation date, result in a policyholder dividend obligation (PDO). This essentially represents excess earnings that are due to your policyholders that need to be set up as a liability. Those excess earnings need to be paid back gradually in the dividend scale. Note that any items of other comprehensive income that are related to the closed block do get included in the PDO. If you have losses in this calculation, because your experience is worse than anticipated, they are first used to reduce any PDO that you've set up and then is reported in other comprehensive income. You never have a negative PDO or a policyholder dividend asset.

Another item that the task force addressed was the appropriate accounting for dividends that are paid related to an MIHC. To the extent that the newly formed stock insurer pays a dividend to the MIHC, regular GAAP accounting is used, which essentially means a cash dividend is a liability when it's declared.

Stock dividends are accounted for per the bulletin that relates to the accounting for stock dividends; in the consolidated financials of the company, those dividends are essentially eliminated. If a dividend is paid from the MIHC to its members, it's considered a policyholder dividend unless the conditions that are listed are all met. There need to be significant third-party stockholders and a mechanism to ensure that the dividends are not a component of the MIHC distribution. All the MIHC members must be eligible, and it must legally be a membership distribution. And finally, if a policyholder dividend is paid through a subsidiary, there are a couple of items that relate to the accounting for that as well.

Now for the exciting topic of the day. The PDO, represents the excess earnings that are accumulated related to the closed block. Table 1 is a simple example of a baseline projection that is without demutualization. This comes out of SOP 95-1.

TABLE 1
Baseline Income Statement

Year	Premium	Interest on NLPR*	Interest on Current Activity	Death Benefits Incurred	Surrender Benefits Incurred	Recurring Expenses Incurred	(Increase) Decrease in NLPR*	Dividends Incurred	Estimated Gross Margin
1	\$210,000	\$0	\$16,244	(\$9,000)	\$0	(\$18,900)	(\$126,103)	(\$18,857)	\$53,384
2	184,611	10,719	14,280	(10,549)	0	(16,615)	(109,116)	(21,399)	51,931
3	169,621	19,994	13,120	(13,731)	(7,148)	(15,266)	(93,669)	(24,230)	48,691
4	155,763	27,955	12,048	(14,835)	(14,984)	(14,019)	(79,754)	(26,574)	45,600
5	142,990	34,735	11,060	(15,661)	(21,760)	(12,869)	(67,117)	(28,509)	42,869
6	131,222	40,440	10,150	(15,622)	(17,237)	(11,810)	(73,236)	(30,043)	33,864
7	124,333	46,665	9,617	(16,578)	(20,989)	(11,190)	(66,499)	(32,301)	33,058
8	117,768	52,317	9,109	(16,824)	(24,427)	(10,599)	(60,005)	(34,367)	32,972
9	111,526	57,417	8,627	(17,526)	(27,566)	(10,037)	(53,706)	(36,230)	32,505
10	105,582	61,982	8,167	(18,603)	(30,406)	(9,502)	(47,485)	(37,915)	31,820
11-20	779,517	760,283	60,296	(311,112)	(398,831)	(70,157)	(162,077)	(424,092)	233,827
21-55	589,392	1,222,685	45,589	(1,187,632)	(686,079)	(53,041)	(938,767)	(669,668)	200,013
Total	\$2,822,325	\$2,335,192	\$218,307	(\$1,647,673)	(\$1,249,427)	(\$254,005)	\$0	(\$1,384,185)	\$840,534
*NLPR – Net Level Premium Reserve						Present Value at earned rate of 8.5%		\$371,261	

Then we're going to assume the demutualization occurs in the sixth year of the projection. The closed-block business is all whole life policies. We're assuming an earned rate of 8.5% for the initial calculation, no expenses or taxes in the closed block, and the premiums and expenses are all at the beginning of the year and benefits are all paid at the end of the year

For comparison, Table 2 is the closed-block piece of this calculation. The items that change are shaded. Essentially it is the piece of your initial income statement associated with your closed-block policies. For example, there are no expenses in the closed-block component of the calculation. Then we've assumed that in year six (the first year after conversion) rather than earning 8.5%, which was the basis for the actuarial calculation, the earnings rate is 9.5%. The interest earned is higher than in the initial projection and those excess earnings need to somehow get back to the policyholders through dividends.

TABLE 2
Closed Block Income Statement

Year	Premium	Interest on Closed Block Assets	Interest on Current Activity	Death Benefits Incurred	Surrender Benefits Incurred	(Increase) Decrease in NLPR	Dividend Incurred	Estimated Gross Margin	(Increase)/ Decrease in Policyholder Dividend Obligation	Closed Block Initial Estimated Gross Margin
1-5	N/A	N/A	N/A	N/A	N/A	(\$475,759)	N/A	N/A	N/A	N/A
6	\$131,222	\$11,200	\$12,466	(\$15,622)	(\$17,237)	(\$73,236)	(\$30,043)	\$18,750	(\$2,491)*	\$15,254
7	124,333	17,839	10,568	(16,578)	(20,989)	(66,499)	(33,061)	16,613	549	16,164
8	117,768	24,819	10,010	(16,824)	(24,427)	(60,005)	(35,127)	18,214	595	16,809
9	111,526	31,298	9,480	(17,526)	(27,566)	(53,706)	(36,990)	16,515	646	17,165
10	105,582	37,266	8,974	(18,603)	(30,406)	(47,485)	(38,675)	16,653	701	17,356
11-20	779,517	585,648	66,259	(311,112)	(398,831)	(162,077)	(424,092)	135,312	0	135,312
21-55	589,392	1,103,633	50,099	(1,187,632)	(686,079)	938,767	(669,668)	138,512	0	138,512
Total	\$1,959,340	\$1,811,703	\$167,856	(\$1,583,897)	(\$1,205,535)	\$0	(\$1,267,656)	\$357,569	\$0	\$357,569

*Interest increased to 9.5% in year 6

In the first year after conversion, the estimated gross margin (EGM) does not change because a PDO is set up that essentially is the excess earnings from the extra interest, which needs to be paid back through dividends. In the subsequent years, the change in the PDO is a positive amount (denoting a decrease) because the excess interest that was earned in the first year after conversion is gradually

paid back in dividends to your policyholders. The end result is that in the closed block there's no change in gross margin.

Table 3 shows the other half of the income statement, representing what's remaining in the open block. Here you also have excess interest earnings in year one after conversion that change your EGMs estimated gross margins just as those margins were changed in the closed block. In the PDO, you have a change in the gross margin in the year of the excess interest earnings, then subsequent to that things get back to normal over time.

TABLE 3
Open Block Income Statement

Year	Interest On Open Block Assets	Interest on Current Activity	Recurring Expenses Incurred	Open Block EGM	Closed Block EGM	Total EGM	DAC Amortization
1-5	N/A	N/A	N/A	N/A	N/A	\$242,474	\$63,336
6	\$33,998	(\$1,122)	(\$11,810)	\$21,066	\$16,259	\$37,324	\$9,409
7	29,037	(951)	(11,190)	16,896	16,162	33,058	7,263
8	27,663	(901)	(10,599)	16,163	16,809	32,972	7,854
9	26,234	(853)	(10,037)	15,344	17,161	32,505	8,248
10	24,776	(807)	(9,502)	14,467	17,354	31,821	8,535
11-20	174,635	(5,963)	(70,157)	98,515	135,312	233,827	66,591
21-55	119,052	(4,510)	(53,041)	61,501	138,512	200,013	70,265
Total 6+	\$435,395	(\$15,107)	(\$176,336)	\$243,952	\$357,569	\$601,520	\$178,164
Grand Total						\$843,994	\$241,500

Interest increased to 9.5% in year 6

The task force concluded that a PDO should be created to prevent premature recognition of shareholder profits. It also reflects the fact that those excess earnings belong to the closed-block policyholders and not the shareholders. And, as I mentioned earlier, to the extent that the experience is worse than anticipated, you do not set up a policyholder dividend asset.

Finally, just a few additional implications of these calculations. The closed-block activity is reported on a pretax basis. The actuarial calculation is unlocked only in extreme situations—one example would be if you had very severe lapsation. In that case, you may end up with your closed block running off much sooner than expected. Obviously that's going to have an impact on the gross margin stream associated with that business. Finally, DAC amortization is calculated after the PDO adjustment.

Mr. Kenneth A. LaSorella: I'm going to introduce a short-cut approach, a balance-sheet approach, and then address implementation issues, all related primarily to the PDO. Let's start off with a few basic definitions. Closed-block assets (CBAs) are on a book-value basis, which means that the available-for-sale-assets are not marked-to-market yet because this is basically an income approach. We want to define the closed-block deficit, although Tricia correctly defines the term net closed-block liability, which will probably be the term used in a future draft by the task force. For now, let's say closed-block deficit is defined to be the difference between the net level premium (NLP) reserve and the closed-block assets (CBAs) on a book-value basis.

Working with that at the date of demutualization, we want to make a best-estimate projection, with no provisions for adverse deviation, and best-estimate assumptions of everything that's going to be in the closed block. You have to project the assets, which means including taxes and fixed as well as variable expenses if the closed block is charged with these items. We project NLP reserves and CBAs, and then the PDO could be defined fairly simply by saying, "Let's look at the projected closed-block deficit less the actual closed-block deficit." On a balance-sheet basis that would give you the cumulative income.

Let's suppose we don't have any taxes. If the projected closed-block deficit was \$40 million and we find that in actuality it's \$30 million, \$10 million would be available to give to the policyholders. However, if we don't tax-effect that and we just put \$10 million up on the balance sheet, our tax-accounting friends will probably go to the other side of the balance sheet and set up a deferred tax asset of roughly 35% of that, leaving a net number of only \$6.5 million. If we do have \$10 million to payout, we need to gross it up. Let's suppose that equals approximately \$15 million. We'd have a liability of \$15 million and a deferred tax asset of roughly \$5 million so we would have the right net number. The PDO needs to be pre-tax.

The gross margin, is just a classic SFAS 120 SOP 95-1 gross margin. It's essentially gross premiums, interest on the NLP reserve, which is important, and on cash flows, and all of the other cash outflows such as maintenance expenses, claims, renewal commissions, etc., as well as the change in the NLP reserve. The dividends in this gross margin are only annual not terminal. Now, working with that basic SFAS 120 definition, we want to subtract from the SFAS 120 gross margin the change in the PDO.

As Tricia already said, we can't have a negative PDO. I'll define the exposure draft gross margin as typical gross margin less change in PDO. Now, you can make a projection at demutualization and, typically, you might hear words such as, "glide path gross margin", or "glide path closed-block deficit." Sometimes they're referred to as "gross margin", sometimes "closed-block deficit", as far as what's actually on the glide path. But the important thing is it's done on best-estimate assumptions at the date of demutualization.

I want to introduce some implementation problems based on where the PDOs are coming from. First, we could have PDO arising from things inside the gross margin. A typical item might be favorable mortality. Second, PDO could be related to items outside both the gross margin and SOP 95-1. Finally, they could be outside the gross margin but actually covered by SOP 95-1.

For the first case, the source of PDO in the gross margin, for example mortality, might be \$10 million better than expected. These are almost no-brainers because, as you would expect, the gross margin would be the typical gross margin defined by SOP 95-1 and would also now include favorable mortality experience relative to the projection. Then we'd subtract the change in the PDO and the favorable variation would basically go away. We'd be right back to our projected or glide path gross margin.

As you pay the extra dividends out in the future, that will reduce future gross margins and then essentially you'll take down the PDO to help you get right back to the glide path gross margin. It seems from this approach that everything should wash, and we should be right back to the original glide path gross margins and have nice stable shareholder income.

However, you could have sources outside the gross margin, which I'm calling nonmodeled just to simplify it a bit. Examples of these include supplemental benefits, such as accidental death benefit (ADB), and waiver of premium. Although they could, sometimes actuaries don't model those as part of the gross margin. Even if you did model these items, you probably would not model extended term insurance profits and make them part of the gross margin to amortize DAC. The same holds for profits from supplementary contracts or dividends on deposit, etc., yet the closed block might be funded for all of these items. If the closed block has assets backing up these types of liabilities, then there will be some sources of profit. If the closed block makes profit, it has to go back to the policyholder—it can't be given to the shareholders.

Once the contributions on the nonmodeled items are captured in the PDO, they're locked in. The change in the PDO is going to be subtracted from the gross margin. The trouble is your gross margin is going to be reduced because it won't reflect any of those items like extended term, but the PDO is already established so this will wreak a little havoc with the income. A potential solution, and this is just a recommendation, that you'd have to work out with your auditors, would be to basically redefine the gross margin to include the contributions from these other sources. If you were to model things perfectly, you may have had ADB in the gross margin anyway.

The sources that are outside the gross margin but covered by SOP 95-1 aren't as easy. Anything that's deferrable—essentially deferrable commissions, acquisition expenses and terminal dividends—are not in the gross margin, but they are addressed by SOP 95-1. They're not in the gross margin because the gross margin is used to basically fund them. A piece of the gross margin will amortize DAC and another piece will accrue a terminal dividend liability. The problem you have is that it wouldn't be as easy to increase our gross margin because of the profits that we've made from this, because we're pretty far removed from SOP 95-1 if we do that. I don't think we can do that. Even if we could, I think that's a minor problem.

A more major problem is that we unlocked DAC and the terminal dividend liability. We're going to go all the way back to issue and present value all of the deferrable expenses. If they're \$10 million less than we thought, we're going to have a different amortization percentage. This means a different income stream to the shareholders because these would not impact the gross margin.

What's the solution for this one? We'd really be reaching if we locked into a DAC amortization percentage and redefined the gross margin to include terminal dividends and deferrable expenses. Then we can't really say we're applying SFAS 120. In this case, we probably have to live with some volatility. Any objective to

neutralize all of the income and to stabilize everything would be far too ambitious. A little bit of volatility is probably OK. And by the way, there's less volatility with the draft approach than there would have been with the traditional SFAS 120 SOP 95-1. It becomes a smaller number and it goes in the conservative direction.

There's very little guidance regarding par new business post-demutualization, except that basically you should apply paragraphs 41 and 42 of SFAS 60. To paraphrase paragraph 42, very roughly, it says income that cannot inure to the benefit of stockholders basically has to be set up as a dividend liability. You can't really give that income to the stockholders so you have to set it aside for the policyholders. I think it would be awkward to try to use the exact closed-block approach that's defined in the exposure draft, because you'd have to have a projection for every issue-year cohort and then apply the concept of a PDO to each cohort.

That would be too cumbersome. It might be easier to apply normal SFAS 120 SOP 95-1, establish your DAC, establish your terminal dividend liability, and then examine the GAAP surplus. If GAAP surplus is negative, that means that the accumulative earnings to shareholders are negative at this point, they're losses. It doesn't matter if the individual year has a very large positive gain. However, once that surplus is about to turn positive it means that you're giving income to the shareholders. At that point, let's say surplus would have been positive \$10 million. If there is a restriction, say, if an entire 90% has to be paid to the policyholders, then you should set aside 90% of that number for policyholders. Dave Rogers was instrumental in developing this methodology even though he doesn't know it. But I think it's a good method. The other 10% could go to the shareholders.

The minor problem with this is that you want to make sure you don't get into an infinite loop. You have set up what I'll call a deferred dividend liability (because I don't want to call it PDO), but you don't want the change in this deferred dividend liability to reduce the gross margin. Otherwise, as soon as you do you'll find that you'll be recalculating the deferred dividend liability and you'll be in an infinite loop. It makes sense to do a one-time calculation. It will probably be close enough, but that's something you'd have to work out with auditors.

I'm going to cover interest on PDO a little bit. Essentially, if you follow SOP 95-1 blindly you earn interest only on the NLP reserve and the cash flows, and that could be a problem. This is best explained with a numerical example. Let's suppose we have a projection where a closed-block deficit is supposed to be 40 and we find in actuality we have 30, even though the NLP reserves are the same. We may have had favorable mortality and our assets are ahead of schedule. This means we're going to have, with the short-cut method (the balance-sheet method), a PDO of 10.

The problem is the mere existence of that PDO means those extra assets are going to earn investment income. We have extra assets in the fund, which means that we're going to increase the PDO. The PDO would grow from 10 to 11. Well, that change of one is going to be subtracted from the gross margin. When we look at the contribution from investment income to the gross margin, if we just apply classic SOP 95-1, we're only going to get 10 (because the interest assumption was

10% for simplicity). Ten percent of the NLP reserves is all we're going to have even though we have a PDO. When we subtract the change in the PDO from that contribution from interest, even though every assumption may have been perfect and the past gains are fully funded, we're going to have a different gross margin. That would impact the DAC amortization and the shareholder income. That doesn't make a lot of sense.

This may be reaching a little bit, but as a potential solution you could define open-block assets to be NLP reserve less than net closed-block assets. Net would be defined as CBAs less the PDO, because the PDO is an obligation in the closed block as opposed to some shareholder obligation. If you did it that way, then you could earn investment income on both the open-block assets and the closed-block assets. In our numerical example, you'd end up generating 11 instead of 10. When you put in the change in the PDO, you could be back to 10, which is what we want.

Or you could take the bull by the horns and simply redefine gross margin to say we're going to earn interest on not only the NLP reserve but also on the PDO. I did propose that to the committee that produced the exposure draft, but I didn't get any response on that one. But that's a little bit aggressive because you're basically almost bypassing SFAS 120 or SOP 95-1, and I don't think they want to do that.

A few miscellaneous items: I told the truth, but perhaps not the whole truth and nothing but the truth, when I said that if items are in the gross margin, they're no problem. It's not exactly true, but it's close. Let's suppose you make \$10 million extra investment income. The gross margin is raised by \$10 million and the PDO is also \$10 million in a no-tax scenario. That means you're back to the glide path gross margin, so that part isn't a problem. You're given a choice based on cohorts where you could either lock into an interest rate or you could choose to have dynamic interest rates. If you choose dynamic interest rates, then the mere fact that you had more investment income means for that year you're going to have a different earned rate, which means when you present value the gross margins, you're going to have a different number. That could give you a different DAC amortization and different income to the shareholders. It's tough to stabilize shareholder income.

The solution involves granting fresh start. It is not a solution for you; it is a solution for the AICPA. The committee could have said, on the day of demutualization if you want to lock into an interest rate, you can. I think that makes sense, but that's up to the AICPA committee.

SFAS 97 universal life (UL): If you have a worldwide organization, in the U.K. especially, you might find SFAS 97 products that are participating. You might find them here in the U.S. as well, and if they're part of the closed block, then what do you do? SFAS 97 tells you to do something one way and then this exposure draft is dealing with a PDO concept. I think the PDO concept is valid and should be applied but the exposure draft came up a little bit short. It just referred to SFAS 120 products. It probably should have said whether it's SFAS 60, SFAS 120, or SFAS 97, listing about 5 FASBs, the same treatment applies; otherwise, the auditors will

tell you to take loss recognition. If you find that you are starting to accumulate funds for UL, you might end up taking some loss recognition.

I'm not going to get into taxes. They are beyond the scope. Just a warning, this is similar to non-modeled items, because, if there's a change in tax rates that you're charging the closed block, taxes are not in the gross margin. It's the same concept, the gross margin doesn't change, yet you will have a PDO that could also cause income volatility.

I'll mention net unrealized gains last because it doesn't really influence income per se but it does influence GAAP equity. Maybe it influences slightly the ROE. This may seem a little weird, but the net unrealized gains on available-for-sale assets at the day of demutualization stay where they were just before. I think it's because the task force didn't want a discontinuity between GAAP surplus, before and after demutualization. That's the only thing I can figure that would motivate this. Because if you decide to apply SFAS 115, which says let's pretend we sell all the available-for-sale assets, and then change all the assets and liabilities accordingly, you'll get a different answer.

Let's take a look at that. SFAS 115 says, sell all the available-for-sale assets. Now we have these realized gains (assuming they were in a gain situation). That means the closed-block deficit is improved, at least temporarily. That means we would set up a PDO because those assets don't belong to the shareholders. They're closed-block assets. If we would set up a PDO then the next question is, "Well, why wouldn't this lead to a shadow PDO?" I think that's the right answer, but I don't think you can get the committee to move on that. For now, I think we're going to be stuck with the method that's described in the draft.

As far as materiality, just to put your mind at ease, if you assume that 70% of the gross margin would have gone to some DAC amortization anyway or accrual of terminal dividend liability, there's 30% left over. Of the 30%, you have deferred tax, so you would be in the ballpark of 20%. With classic shadow applications, you'd end up with 20% spilling into the GAAP equity. With the shadow PDO approach, zero would fall into GAAP equity. The differential is only between 20% and zero.

Mr. Brian Purves: I'm going to go into a little bit of history. It's useful to put that into context to understand where some of the U.K. participating business has come from and how you might go about applying it into U.S. GAAP. It would be fair to say, looking at all the major U.K. life companies at the moment, if they haven't got an SEC listing, they're either in the middle of a process for getting one or expect to have one very soon. It's a hot topic in the U.K. at the moment.

In the 1760's Equitable Life was the first insurance company to set up a business in the U.K. It was a mutual, but very soon afterward we got into having some proprietary life companies with shareholder/policyholder ownership. Originally when a participating business was set up, a typical contract was an endowment. We would tell the policyholder that we expect to make profits over time, and we're going to share those with you. The way we do that is through the concept of

reversionary bonus. The way that works is that the benefits you get increase by a fixed proportion of the sum assured every single year.

When one of those bonuses is declared, the shareholder gets a proportion of it; typically in the U.K., we have what's known as the 90/10 gate. If you give 90% to a policyholder, shareholders can take 10%. There's a timing difference here. The policyholders will get it at maturity. Shareholders can take it immediately.

That situation continued for about 200 years. Things didn't move quickly in the U.K. life industry until 1960. Given a background of much higher inflation and booming equity markets, there started to be a much higher proportion invested in equities. If you look at today's typical U.K. life company, it will have about 80% of its assets in shares. That's very different from the U.S. environment. That has led us to start dealing with bonuses in a slightly different way.

In the 1960s, the reversionary bonus scales kept going. However, there were some really big gains coming through and you had to think about how to distribute them to the policyholders. Good, prudent actuaries weren't too keen to distribute those gains, especially if they weren't realized as reversionary bonuses. Moving on into the 1970s, they started to come up with more back-end-loaded bonus scales, terminal bonus being the obvious one. They also started playing around with the way the reversionary bonuses were described. You might get a lower percentage of sum assured, but you'd get a higher percentage of bonus-on-bonus. That might be typically 3% of sum assured, and 7% on bonus. That means, as far as the policyholder is concerned, their benefits ratchet up much more quickly toward the end of the policy.

To put terminal bonuses in context, probably during the 1980s about 50% of the final payouts on endowment contracts were in respect of terminal bonuses. That's a very large proportion of your benefit being based on effectively unrealized gains coming through the stock market.

Moving toward the 1990s, companies started to have more problems with capital management and were looking for ways to reduce some of the capital strains on financing some of this business. Unitized-with-profit started to be sold. Now unitized-with-profit is effectively UL, but you're investing in a with-profits fund. Why is that a great thing compared to investing straight in equities? Well, the sales pitch is that there are a lot more smooth returns coming out in a with-profit fund. If your policy matures one day and the stock market crashed the day before, you wouldn't expect to get affected by that as much as you would if you had a straight equity fund. That's the history and pretty well where we're up to today.

It's worth having a look at U.K. statutory reporting because that tends to take you through to where you might get in a U.S. GAAP basis. U.K. statutory reporting is for the regulators. It's to prove that you're solvent, to show that the policyholders are protected. Reserves are on a net premium basis, that's U.K. net premium, which means no assumed future lapses. Interest rates are very low. Because of that you have a very prudent basis on which you've reserved for sum assured and for any bonuses declared to date. One important thing to say is that you don't have to set

up an explicit reserve for terminal bonuses or any future bonuses, which supposedly gives you much more investment freedom. If you suddenly have to start reserving for those, you may have to shift to a much higher proportion in bonds as a result of U.K. regulations regarding the way you value these liabilities.

Fund accounting, is a very odd concept. Every junior actuary who ever comes through the ranks asks, Why are you doing it like this? But that's the way it is. The heart of the concept is the long-term business fund, which is essentially equal to the overall liabilities for those with-profit policies. If you look at the money that goes in and out of that fund, you have premiums, dividends income or interest-earned income, expenses that will come out of the fund claims, including any terminal bonuses, and any transfers you're going to make to shareholders.

Once a year an appointed actuary does his or her valuation and asks, "Do I have enough money in the long-term business fund to: 1) increase my reserves? 2). increase reserves in respect to any bonuses I want to declare? and 3). increase reserves in respect to any terminal bonuses I've paid out the door?" At that point, he or she says, "I have this great big pot of capital gains sitting here in the investment reserve and there's just a notional transfer that goes across from the investment reserve into the long-term business fund." That's purely on a needs basis. It would be fair to say that a lot of reversionary bonuses that are being declared off the back of unrealized gains have been made in the stock market, particularly the way things are at the moment.

Where does this get us? What is left is an investment reserve which is going to be paid to some policyholders in respect to future terminal bonuses and future reversionary bonuses, but also in the reserve is a large lump of shareholder cash. In U.K. statutory reporting that is not separately identified. What is worried about is, do I have assets, minus my policyholder guaranteed liabilities? And there's no split of that difference between shareholders and policyholders. It's not a great reporting method, but it's based on solvency.

Because of this needs transfer, the actuary can pretty well declare whatever bonus he or she wants and that triggers a transfer to shareholders. Shareholder profits are derived from this bonus that gets declared. How that actually ties up performance-wise with what's happened over the year is actually quite difficult to see.

The only thing you can say is that the only way shareholders will only ever get 10% of overall surplus that's generated is over the full duration of the whole life company. There's no real match-up in performance over the year and it's quite an interesting one because the only thing you can actually pay is a dividend to shareholders. A shareholder transfer is derived on the U.K. statutory basis. It gives some hefty restrictions on what shareholders can get their hands on.

The second out of three U.K. methodologies is achieved profits, which is very much embedded value accounting. Most of the major U.K. life companies publish embedded value results and those are the ones the analysts focus on.

Straight U.K. GAAP is not taken as seriously as it might be in the U.K. There are some big European Community directives about how all insurance companies ought to be producing accounts on a similar basis. Almost every country in Europe did the bare minimum to meet those requirements. It's fair to say reserve-wise, there aren't really any major differences. For U.K. GAAP, you're basically basing your reserves on these very prudent reserves that are set up for solvency purposes so, again, is this a realistic reporting methodology?

A few modifications help put it put in place. It's even called modified statutory. You set up a DAC asset. The definition of what you're allowed to defer is much more than you might do under a U.S. GAAP basis. There is loss recognition. However, patterns of amortization are pretty much at the discretion of the actuary.

U.K. GAAP talks about using margins that emerge. Some people use it proportionately over the whole term. Some people take first margins. You end up with some very odd profit recognition patterns coming out of the U.K. modified statutory.

Probably the most important thing to mention on this is that, once again, they fudge the issue of ownership of these sort of free assets. Despite the fact that you have a 90/10 restriction for most U.K. stock life companies, they are allowed to use this thing called a fund for future appropriations, which is basically all the money sitting there that you expect to give to policyholders for future terminal bonuses, perhaps even future reversionary bonuses, plus any cash you expect to give to shareholders. Also, in most U.K. life companies you have a large amount of assets that aren't really allocated to anybody yet. A lot of that has to do with actuarial prudence over the years, in particular in the '60s when they built up lots of gains on assets and didn't distribute them.

Within U.K. life companies there's about £20 billion worth of assets sitting there that policyholders or shareholders may own and there are some interesting fights going on with U.K. regulators to enable shareholders to get their hands on that. AXA has just introduced a scheme that's going public. They have about £2 billion worth of orphan assets in their U.K. life company and they're going to policyholders and saying, "We will give you £500 million of it, and we'll take £1.5 billion. Otherwise, you get nothing, unless we decide to distribute in the future." The U.K. regulator is unable to argue against that. It's going to court and we will see where that comes out. It's an interesting issue.

That's all the background to U.K. basis. We have all these parts of assets that aren't really allocated to anybody. In the background to all this not terribly transparent reporting, a lot of internal measures are used to make sure that you're giving the right amount of money to your policyholders. It's called asset shares. For instance, you basically accumulate all the cash on a particular policy and you try to target final payouts so that the amount of money you've had in respect to that contract roughly ties up. There's some decent actuarial modeling going on in the background, but the outside world isn't getting to see an awful lot of that.

Now the fun bit. From a personal perspective, I've been involved with about five life companies that have converted over the last few years and it's a very, very painful process. U.K. products do not fit well into U.S. GAAP so you have to try to apply some sort of sensible rules of thumb. The first thing to say is that U.K. participating business probably doesn't satisfy the criteria of SFAS 120. There are two rules at the front, one about declaring annual bonuses, which we do; the second one about having to follow the contribution method. As I mentioned before, we don't follow anything like the contribution method so you drop quite quickly out of SFAS 120 to go searching elsewhere for your accounting basis.

Assets typically are being treated as trading. A lot of the problem with this is if you go for an available-for-sale approach and you declare bonuses that will hit your income statement, you may not have enough realized gains coming through to fund those bonus increases. So you end up with big drains on shareholder net income if you're not careful.

Where do we get to on a conventional U.K. with-profits business? Unitized is another problem. Reserves are based very much on a straight SFAS 60 approach. Paragraphs 41 and 42, include an approach to follow, if there are restrictions on shareholder takes. We've decided for most U.K. life companies where there is this concept of a 90/10 gate, that is deemed to be a restriction on shareholder net income. Although you heard my description earlier that shareholder profits are based on one-ninth of whatever the actuary decides to declare as a bonus, on an annual basis that test doesn't work. The company could just keep increasing bonuses and shareholders could take what they want, but over time, it would be fair to say that shareholders can only get 10% of profits.

That pushes you quite quickly into, paragraph 42 of SFAS 60, where you set up a reserve on a U.S. net premium basis allowing for bonuses declared to date. Now, what do you do with future bonuses? In paragraph 42, there's this concept of a policyholder bonus that could even be called policyholder bonus obligation, if we look at the SOP we talked about a minute ago. But basically, the net income is generated every year. You split it between policyholders and shareholders. Stage one, you look at the U.S. GAAP net income before you declare any bonuses or pay any terminal bonuses out the door, and you can 90/10 that. The 10% goes straight through to shareholder net income in the end, and the 90% goes into this policyholder bonus fund.

On a U.K. basis, because the amount of our terminal bonuses is so high, the policyholder bonus obligation is enormous for some companies. The SEC was having difficulty understanding the nature of that obligation. To be honest that is what forced us to go down a trading route; if you go into an available-for-sale approach there, as Ken said, ideally you're sitting there with a whole bunch of unrealized gains on your balance sheet. You probably ought to be 90/10ing those or putting 90% of them into a shadow policyholder bonus obligation. My understanding is that the SEC had serious problems with that because a big change in a policyholder liability is not going through the income statement. That might have some implications for some of the demutualizations that you are getting into.

There are other things that are a complete nightmare under U.S. GAAP. We have a marvelous tax called I minus E, which is basically a tax on investment income minus expenses. It's not a profits tax. When you try to set up some of these liabilities, you probably have to do them on a net basis for life business or else you get very quickly into loss recognition problems. Some of the income statements start looking very silly. How that fits into U.S. GAAP is quite tough but it would be fair to say that it takes some interpretation. Similarly on the unitized-with-profit business, we also have non-participating business that sits within a with-profit fund so the only way shareholders can get their hands on that money is for it to get declared as a bonus to policyholders. Again, we've been able to set up a policyholder bonus fund for that business. There have been big discussions with the SEC as to how we've been doing that, but it's not very clear from the literature how you'd get to that, especially when the unitized with-profit business is very clearly a SFAS 97 product, either UL or an investment contract. You actually have to stretch some of the rules a bit to make some of the numbers look sensible.

Another area of difficulty is with profit deferred annuity contracts, which are basically retirement savings plans. There's no real policyholder account balance. These are pretty clearly investment contracts because until maturity there's very little mortality risk to the insurance company. The policyholder gets back return of premiums with interest. That's caused some real problems in trying to convert these into U.S. GAAP, particularly where you have to come up with a SFAS 97 style account balance.

Those have been some of the difficulties we've had. The most interesting one is probably the use of this policyholder bonus account and having to deal with the ways the assets and the liabilities move together. That's been a serious problem for us with very large equity backing ratios.

Mr. Frank S. Austin: Just a clarification on the point that the reserves are based on a SFAS 60 approach for sum assured and reversionary bonus declared to date. Let's say you have a product that's a single premium product, a big bonus paid at the end of ten years, and cash value equals the premium for that ten-year period. It's invested completely in equities. Things happen. Are you reserving only for the sum assured and the bonuses declared to date? In this example, the bonuses would not be until the tenth year.

Mr. Purves: That's right. If the only bonuses you were declaring were in the tenth year, that's all that gets reserved, but if you look on both the U.K. and the U.S. base, the difference between the premium and the reserve you set up would drop into this policyholder bonus fund if you'd like. It's there implicitly.

Mr. Austin: You would be holding reserve for the future bonus?

Mr. Purves: Yes, but the way you calculate it wouldn't be as a discounted cash flow based on what you would expect.

Mr. Austin: But it's included in the GAAP reserve?

Mr. Purves: Yes.

Mr. Austin: What if something changes along the way? Let's say you're in the ninth year in this example, and the market just drops 40% and you can't pay that bonus? Do you send a notice out to policyholders saying sorry, but the market collapsed so I'm paying you 60% of what we illustrated? Or do you change the reserve at that moment?

Mr. Purves: The basic reserve doesn't change, but the way you would establish the policyholder bonus looks at the assets minus liabilities. If the asset value dropped suddenly, then that liability would drop as well. There are issues about smoothing. If on a realistic basis you did expect to pay more than your asset value, then we get into loss recognition testing and recognize that extra liability.

Mr. Vincent Y. Y. Tsang: I just want some clarification on the PDO. You mentioned that we are not allowed to have a negative PDO in the balance sheet, am I correct? Are you saying that we are not allowed to show a negative PDO or we cannot have a negative PDO? Let's say, in the first year you have very bad experience that leads to a theoretically negative PDO. In the second year, you have a favorable experience that exactly offsets the first year deficit. If you aren't allowed to show a negative PDO, then at the end of two years you would get back to where you're supposed to be, but under the no negative PDO, you would have a positive PDO after that.

Mr. LaSorella: Yes, what you described is correct. You want to do things on an accumulative basis so if you would have had a negative PDO, you basically just store that because it's accumulated earnings. You just put it aside so it wouldn't show up on a balance sheet. But in your example, the very next year you had favorable experience and let's suppose you totally wiped out the negative. Let's suppose you even exceeded it by \$1 million, then you would see a \$1 million PDO. Do you just keep track?

That first year when you had that negative, some would argue that you should be allowed to set up a negative PDO and re-establish the glide path. Whereas, by not allowing us to show a negative PDO, you would basically unlock your assumptions and you would influence shareholder income.

Mr. Wagner: Ken, when you talked about the net unrealized gains and the situation that develops where you can't do the shadow PDO, can you elaborate on whether that is only with respect to unrealized gains that exist at the time of demutualization as opposed to unrealized gains that would develop in the future?

Mr. LaSorella: If you take a look at the net realized gains at the date of demutualization and you tag every asset, that's what you want to track for the shareholders. Any subsequent unrealized gains on those same assets also belong to the policyholders. And certainly any gains on any new assets you purchased after the date of demutualization would go to the policyholders. A shadow PDO will exist with this new exposure draft, but not with respect to gains that were locked in at the date of demutualization. For those, we must wait for them to run off; i.e., some

will mature, default, be sold or traded. You have to wait for those assets to go away, which means you might be tracking them for 20-30 years. It's unfortunate, but it looks like that's what we're stuck with right now.

Mr. Wagner: Tricia, you talked about the actual calculation that gets set up and sometimes the term "glide path" is used. In setting up a closed block, there are best-estimate assumptions and then there's what ultimately happens after some discussions take place say with the regulators. The results might not be classified as best estimate. Could you comment on what the basis for assumptions is supposed to be, under this accounting standard as opposed to other things that might be in place for statutory purposes?

Ms. Matson: It would be nice if you could use this statutory calculation that you do for purposes of setting up the glide path. In reality, as Darryl mentioned, the closed-block calculation that you do to comply with regulations could in some instances be described as best estimate, but in reality it generally is not. There's generally a lot of back and forth with regulators, so frequently you end up with a closed block that is somewhat conservatively funded for statutory purposes. Using that projection for purposes of setting up the actuarial calculation is probably not going to work out, and in fact, you'd have to redefine best estimate for purposes of the actuarial calculation.

Mr. Purves: I have a question from a U.K. basis. The way demutualization is done in the U.K. is quite different, I think, but the assets dedicated to policyholders have a very clear ring fencing around them you could say. All of these assets belong to these policyholders, and the shareholders will not be affected by them. You sometimes have guarantee funds where shareholders may have to bail people out, but there's basically a pool of assets that will be distributed just to those policyholders. Was it ever thought about when drafting this SOP that maybe you could just treat those as a separate account if you'd like?

Mr. Wagner: I don't know that it was considered but I think a lot of that has to do with the differences between the U.S. and U.K. As you said, it's like the junior actuaries trying to figure out fund accounting in the U.K. There's quite a bit of history built up in the U.S., around both how demutualizations are done and the way the U.S. GAAP pronouncements work. When you combine those two, the kind of thing that you suggested doesn't really work out too practically.

Mr. David Y. Rogers: Previously, I did evaluate using a separate account approach for U.K. business and at that time I think we actually entered into some discussions with U.S. GAAP accounting authorities. I can't recollect whether it was FASB or the SEC that we talked to, but the issue they had was related to effectively market-valuing what were guaranteed obligations to the policyholders, so the discussions kind of collapsed on that basis. Although you could argue that the PDO is a plug and kind of deal with it through that methodology, it just didn't work out.

I had a question for you, Brian. I wasn't aware of the situation you mentioned where AXA had effectively said we'll give our policyholders 25% of the orphaned surplus or we'll just let it sit there and accumulate until we don't have any

policyholders anymore. Have you speculated about the reaction that the SEC might have, to the accrual of what is in effect a 90% liability against these orphaned funds by other U.K. insurers, given that AXA might be able to settle the obligation for a quarter of that amount?

Mr. Purves: This is a very hot topic in the U.K. at the moment. This deal that AXA is trying to make with policyholders will create a precedent and there are a lot of other companies out there, in particular, Prudential, who at the moment in their SEC listing basically said, "We'll take 10% of those orphaned assets." It has been quite clear in its negotiations with the U.K. authorities that it might be able to get more of that money. We're talking about £6-7 billion worth of assets here. That's a very large proportion that they're fighting over. It's a big issue, but putting another hat on for a minute, you could say you'd rather have more shoved away as a policyholder liability than recognizing it and having to unrecognize it years later. It's a very difficult question.

From the Floor: I have a comment on the ring fencing. The ring fencing of assets is fine but from the company's perspective, if you set the liabilities exactly equal to those assets you'll get no income in the future. Yet we still have to put up risk-based capital in Canada, minimum continuing capital and surplus requirements, etc. In order to have a decent ROE, we have to get something out of that block otherwise we'll make a 4-5% ROE after tax. One way to do it is to have assets which would be the net GAAP liability, so we'll say the NLP reserve minus the DAC, less any terminal dividend liability, less the CBAs. Well, that differential is like one large macro provision for adverse deviation, which will gradually spill off into income over time. At least the shareholders get some income. Ironically, at the date of demutualization we wouldn't want to take down the reserves and make them equal to the ring-fenced assets, we'd rather leave them up and allow the income to gradually be given to the shareholders.

Mr. Purves: On a U.K. approach, if you apply separate accounts treatment of the demutualized company, usually a subsidiary of some big proprietary outfit, your equity in respect to those ring-fenced assets would be zero and future income on it would also be zero. Slightly different measures could work out what ROE the company would be getting given its asset base.

Mr. Wagner: The separate account question is an interesting one. Dave, you mentioned some of the historical discoveries, but the way separate accounts have evolved over time to include some guaranteed types of businesses make it an even more interesting question.

Ken, there may be some folks in the room who might be faced with doing some of these calculations, perhaps for the first time, if they're with a demutualized company. Can you share some of the implementation issues in terms of the calculations themselves, the models needed, and facilitating some of these things from a practical perspective?

Mr. LaSorella: Just from a modeling perspective, if you start with the normal GAAP models, you're going to have models by issue-year cohort for SFAS 120 and SOP

95-1, and those models, say for gross margin purposes, have most of the cash flows you need. You'll have investment income on the NLP reserve, you'll have the NLP reserves, and you'll have all the maintenance expenses; renewal commissions, claims, and gross premiums. You'll normally be able to pick up other items such as the deferrable expenses and commissions because those are usually projected in some other portion of a model.

What you probably will not have will be fixed expenses. If you're going to allocate expenses to a closed block internally on some fixed basis, normally GAAP just works with the variable expenses so you have to make sure you put back the fully allocated expenses. Likewise, you won't have taxes in the GAAP model. There would be certain items that you're going to have to modify. You'll have to build a separate module to deal with taxes, and that could be a bit tricky. I recommend that you don't deal with deferred taxes; instead try to actually project current taxes and worry about the tax accounting afterwards, because it's really cash flows that you're trying to project.

The most difficult part of all this is to start with the assets and make the projection. The other subtlety that I sort of glossed over in my presentation is if you have a lot of non-modeled reserves, you should take those away from the assets right off the bat. For example, if you have extended term insurance reserves in the closed block, then take them out so you're working with assets that are only backing up the NLP reserves, essentially the basic plain vanilla business, and make the projection on that basis. The subtlety there is that you're saying that all the non-modeled business would contribute zero even though you know it's going to contribute something, and you wait until the contributions are made and then you handle them. That's probably the simplest way, but it's still not easy. There's no real easy method to make the projection.

The ultimate test, is to start off with the assets and make sure they run to zero. If you put in your best-estimate assumptions and you find that they run out at the end of 20 years, you know you have a problem. Likewise, if you find you have gazillion dollars at the end of a 50-year projection period, you know you have another problem. The way I would make sure they run to zero, would be to put in a dividend provision, like 10 basis points. Have your own internal tolerance limits. With the best-estimate assumptions, if they don't run to zero and you need to modify the dividends by six or seven basis points, that's OK. It just means that your current dividend scale was not totally calibrated, or fine tuned. Most likely you'll find that to be the case. But if you find that you need 180 basis points of dividend adjustments to make the fund run to zero, you have a problem.

Mr. Wagner: Yes, those comments bring up an interesting point. In the task force, there was quite a bit of debate as to the whole PDO concept. There was a school of thought that said you really don't need a PDO even in a closed-block situation, because the workings of SFAS 120 will bring it back to center over time even with real volatility, but obviously the task force came down where it did. One practical benefit of the SOP approach is that when you take on a closed block after a demutualization, one of the things you have to deal with is how do you managing it to keep it from being a tontine, which requires that you get the dividends changed

appropriately. This whole PDO concept is a practical watchdog that will help companies do that and insure that discipline gets enforced.