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Session 100PD Recognition of Sales Inducement and Policy Exchange Credits Under GAAP

Track: Financial Reporting

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Summary: The life insurance and annuity marketplace is experiencing fierce competition, and many life insurance companies have responded to this by offering special product upgrades to their policyholders with the intent of retaining their business. This activity has led to a number of questions relating to the accounting treatment of these programs—specifically, how it should affect the unamortized deferred acquisition cost asset that is accrued under GAAP. A panel of experts provides an overview of this topic and discusses recent Accounting Standards Executive Committee (AcSEC) activities.

MR. JOHN KLEIMAN: We have an excellent panel. All three presenters have worked with the AICPA task force and can provide the latest information on the subject of “Recognition of Sales Inducements and Policy Exchange Credits Under GAAP.”

Mary Saslow is a director in the National Accounting Consulting Services Group of PricewaterhouseCoopers specializing in insurance and financial industry matters. Her principal responsibilities include providing consulting services to the firm’s practice offices on complex and emerging insurance industry accounting issues and formulating the firm’s position on proposed accounting standards impacting the

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insurance industry. Mary participates in various AICPA insurance-related projects and is currently participating on the AICPA task force on nontraditional annuity and life insurance products. In that role she has worked with the FASB staff on various insurance-related Financial Accounting Standard (FAS) 133 implementation issues and has represented the task force in discussion with the FASB's derivative implementation group. Mary is a member of the AICPA and Connecticut State Society of CPAs and obtained her undergraduate degree from the University of Connecticut. Mary will discuss sales inducements and, if time permits, provide some insight into other projects that are being considered by the task force.

Dan Gifford is a CPA, and director of corporate accounting at Nationwide Financial Services. Dan joined Nationwide in August 1999 after spending 11 years at KPMG where he was most recently an assurance senior manager. Dan served a number of clients in the insurance industry during his public accounting career. Currently his primary responsibilities include GAAP and SEC reporting for Nationwide Financial Services. Dan holds a B.A. in accounting from Otterbein College. He's a member of the AICPA and also serves on the AICPA Deferred Acquisition Cost (DAC) on Internal Replacements and Purchasing Accounting Task Force. Dan will discuss sales inducements.

John Morris is an FSA and a principal consultant in the Actuarial Insurance Management Solutions practice of PricewaterhouseCoopers located in the Valley Forge office. He's involved in many areas of the life, annuity, and health insurance actuarial consulting practice as a project manager for many assignments including statutory and GAAP financial reporting, asset/liability cash-flow analysis, insurance company rehabilitations, and actuarial audit support. He's an active member of The Academy's Committee on Life Insurance Financial Reporting and a member of the AICPA's working group on internal replacements. Before joining PricewaterhouseCoopers, John was an assistant vice-president and product actuary for a direct response insurance company. He was also responsible for all functions within the actuarial products area. He's a 1976 graduate of Drexel with a B.S. in math, and he will provide an actuarial view on DAC on internal replacements.

Our agenda will cover what is happening in long duration contracts projects and sales inducements.

MS. MARY SASLOW: As John mentioned, I'm a member of the long duration nontraditional task force at the AICPA. The information I will be sharing on sales inducements is quite timely as our task force just had a meeting, and then met with our parent committee, Accounting Standards Executive Committee (AcSEC).

The impetus for this entire project on nontraditional products was the fact that there were new products being developed in the marketplace, and neither *FAS 97* nor *FAS 60* provided sufficient guidance. One example is the accounting for sales inducements, which we broadly defined as enhanced returns offered with both fixed

and variable products. Initially, we identified them as mostly applying to annuities in the GAAP sense—meaning investment contracts, but we realized that they also are offered with life insurance products.

As we worked through our discussions, we wanted to lay some conceptual framework. So we categorized sales inducements into three main buckets: (1) “day one bonus,” which would be a situation where the contract holder deposits \$1,000, and some amount (say \$100) is immediately credited to his account balance; (2) “persistency bonus,” the \$1,000 deposit comes in, and there’s also a promise in the contract that some amount of bonus will be credited either at the end of a five-year period (a cliff vesting, if you will) or perhaps ratably over some period; (3) “enhanced interest rate,” where the contract states that you make your initial deposit, you get some crediting rate, and you also get a bonus interest rate of some amount (perhaps 2% per year for some initial period).

We were told by the industry to recognize that when these incentives are offered in the marketplace there could be various ways that a company could make up for that cost or put it in its pricing model. One was to reduce the agent’s commission. We saw that especially in the earlier sales inducements. Another was to either implicitly or explicitly increase surrender charges or future mortality and expense (M&E) costs or maybe just to accept reduced margins on the product recognizing the competition.

Why did we pick sales inducements as part of our project? Well, obviously there was no clear guidance. I always know when I start getting numerous phone calls and other firms do also, as we share information, people are asking questions: What’s the practice on this? What should we do? Should we capitalize these costs? Do we expense them? Given the numerous sales inducements that were being offered in the last several years, these questions continued to come. So we recognized that we needed to provide some comparable, consistent guidance.

As I said, some companies have capitalized these costs and amortized them. Some companies have expensed them as they’re credited—day one bonus expense or persistency bonus expense, over the five-year period or the length of the vesting period. There are also differences if they capitalize them in terms of the amortization period. Over what period would you amortize the inducement: over the vesting period, the surrender period, or the life of the contract?

I feel compelled to answer the question of why this is such a tough issue for our task force based on the numerous jibes that I’ve been getting about how the task force has changed its mind three or four times on this issue. Well, the task force never really changed its mind. From the inception of our project, we thought that the appropriate economic answer was to capitalize these costs and recognize them over the life of the contracts. However, there was existing GAAP guidance that we thought conflicted with that logical answer.

We first went to our parent committee, AcSEC, with this issue and said that, based on the accounting literature that exists, (although we think it makes no sense) the answer is that we need to expense these costs. At that time AcSEC was not fully aware of all the issues involved. They agreed that practically this answer was illogical, so they couldn't really support it. They wanted to know more about the issue.

So, in December 1999 we spent a lot of time talking with AcSEC supporting our conclusion of recognizing or amortizing these costs over the life of the contracts. We were pretty confident going into the meeting that we could convince them. But between the time of our original meeting and the December meeting some of the members of AcSEC were replaced. Having new members on this committee has been a constant problem for us, because the task force has been in force for three years now. As we educate these non-insurance people on some of these issues, they leave, and we get new people on board. We went to them with our recommendation to capitalize, and they said, no, we think it should be expensed. One of the big negative voices was one of the banking representatives who said if banks have a cost like this, it has to be expensed, not capitalized.

So we left that meeting disappointed, and then waited a whole year before we actually got back on their agenda to talk about this particular issue. At that time they had more information: two basic views of expense versus capitalize. They said we think both have merits. So they said go back and do a lot of research, support your arguments, write up detailed papers, and tell us where you come out.

That's basically the process we went through. In terms of the accounting literature that I'm going to talk about, and the various views, the liability model and the *FAS 91* model are the models that would support immediate expense. The reason we were there in the first place is that most of the contracts that were offering these bonuses were in the GAAP world referred to as investment contracts. Even though they might be annuities, and for statutory purposes they're insurance contracts, for GAAP they're investment contracts. As investment contracts, they're governed by paragraph 15 of *FAS 97*, which says if you have an investment contract, you treat it like debt. Overall, the treatment of debt needs to be recorded on your balance sheet at any point in time the amount that's payable on demand to the person that you owe the debt to. Therefore, for something like a day one bonus, you credit their account. It's theirs. You need to have that recorded on your balance sheet with the offsetting entry to expense.

The *FAS 91* model, although it relates to assets, arrived at similar conclusions about never having an amount on your balance sheet that if collected would end up with a loss. So, the point was that if we capitalize these costs, and if all the policyholders surrender tomorrow, we could potentially have a write-off. The

alternate view—the spread model—is really an analogy to the long duration UL model, which talks about recognizing costs over the expected life of the contracts.

One of the issues that we addressed (because there were a lot of questions from industry) was the practice of capitalizing these costs and referring to them as DAC, putting them as part of deferred acquisition costs. We analyzed this issue at our task force level, the AcSEC parent level, in our discussions with the FASB staff, and informally with the SEC. We all agreed that we could not refer to these as DAC, because although they might be costs that were incurred to entice new customers, they nevertheless represented amounts that were owed to contract holders. So, first and foremost, they represent a benefit expense—an expense to the contract holder—and not an acquisition cost.

In our re-analysis we asked, what is the best answer and what answer makes sense? Let's see if we can build the argument for it. One of the points which AcSEC considered and agreed to was that immediate expensing, (say, a day one bonus) doesn't really make much sense. A contract isn't meant to be a loss contract. Why should you have an expense recorded on day one? The contract is expected to generate income over its life. It just didn't make sense.

They asked us to reconsider the two potential views: the first view being this effective yield model where we would capitalize certain sales inducements that met specific criteria and then amortize those over estimated gross profits. That would apply to the day one bonuses, persistency bonuses, or enhanced interest yields. We arrived there realizing that while some of these might be investment contracts (and not technically subject to the *FAS 97* UL model), we know that Practice Bulletin 8 pulls in some investment contracts for purposes of DAC amortization and recognizes that you can have a similar methodology for DAC recognition for investment contracts. In effect, DAC represents debt issue costs, and the rule under general GAAP for debt is that you amortize debt issue costs over the life of the debt.

We referred to these bonuses more as debt discount, because we couldn't say that they were acquisition costs. They did not represent debt issue costs, but rather, debt discount (similar to when a bond is issued, and someone paid you \$90 when it had a face value of \$100, and you would accrete to the \$100 amount). Therefore, using that tie-in with Practice Bulletin 8, we reasoned that we could use the *FAS 97* model and also analogize to the DAC model and recognize these debt discount costs over the life of the contracts.

We were also asked to provide our views as to the pros and cons of this argument. We thought we had legitimate support in the literature. It was reasonable to tie it in with *FAS 97* and Practice Bulletin 8 effective yield model. We thought it better represented the economic substance of the transaction, and our methodology would not result in different accounting between different types of inducements.

Another point that bothered AcSEC was that if we immediately expensed, we could have three different types of bonuses that, in effect, economically were the same: a day one bonus, a persistency bonus over five years, or an enhanced interest that could be structured such that on a present value basis they were really the same, but yet on an immediate expense model would get you different answers.

The one negative point in our discussions that we passed along to AcSEC was that we were picking and choosing the components of the *FAS 97* model that we wanted to spread. Why are we just focusing on one feature—the sales inducement term in the contract? Why don't we look at M&E fees, cost of insurance (COI) charges, surrender charges, and maybe some components of those that really were increased as a result of these sales inducements? So maybe we should pick those pieces out and amortize those as well. Why did we pick only sales inducements? There was some concern that there could be gaming going on if we allowed this accounting.

As I said, the alternate approach—the liability approach—would be to expense day one bonuses immediately, expense persistency bonuses, over the five-year period that they're accrued, and expense the enhanced yield as it's credited to the account balance. You have to understand that in recent years this approach of focusing on the balance sheet has become more and more a view of the FASB. The FASB and the SEC are not into a spread model. In general they want to know the amounts that are due or receivable at the balance sheet date. They don't care about income smoothing. So, under the debt model you'd say, what amount is due at this date? That's the amount that should be recorded. But, again, we still believe that doesn't reflect the economics of this transaction. We thought that a better model to look to rather than the debt model was the *FAS 97* model.

Finally, in March 2001, AcSEC tentatively agreed with our conclusion, and I always say tentative because the draft Standard of Practice (SOP) has not even been issued yet. I mean the process is that we meet with AcSEC, then after we get them to agree to all of our tentative conclusions (which we hope will be in July or maybe in the third quarter), then we finalize our draft SOP and present it for public comment. That draft SOP would also have to be approved not just by a 10 out of 15 vote by AcSEC, but also would need to receive negative clearance by the FASB. Anything that I talk about here in terms of tentative conclusions is always tentative and subject to change.

There are really two pieces to the sales inducement in the proposed accounting. Step 1 is that, from the liability standpoint, we believe you need to record the liability for the sales inducement as it's credited. So, in the example of the day one bonus, we would have an immediate credit to the liability balance, and Step 1 would really be debit expense and credit liability. This liability crediting would be made on a total basis assuming no surrenders or withdrawals, similar to the *FAS 97* model.

Step 2 would be to determine if those costs represent costs that can be capitalized. So we developed criteria that need to be met in order to capitalize these costs. First, the bonus needs to be explicitly identified in the contract. We are providing you with an additional crediting rate of x or an additional amount of x . Second, the insurance enterprise needs to demonstrate that these amounts are incremental to what they would typically credit on other contracts or, if that information isn't available, then higher than what they would credit, or what they expect to credit, in the renewal periods of the contract. The estimates that they're using for comparison need to be consistent with what they've shown in their gross profits or contract illustrations.

So assuming those criteria are met, we would capitalize that amount and, again, defer and amortize it over the life of the contracts in a manner similar to DAC. The one thing that the SEC insisted on at one of the meetings (and this is just informal input from the SEC) was that the amortization would be recorded as a component of benefit expense and not as part of DAC amortization, because obviously it isn't DAC.

One of the open issues that was discussed at the recent meeting with AcSEC was the amount that we capitalize or defer. Does it represent an asset or a contra-liability? In other words, should it be shown gross on the balance sheet as a deferred asset or netted against the liability balance? We don't consider this to be a big issue, but if somebody out there does, please let us know. Several (I think it was the FASB staff and others) recommended that perhaps it would be more clearly shown as a deferred asset—more transparent to the financial statements. That would also be supported by the fact that we are following an amortization method similar to DAC, so maybe we should treat it on the balance sheet similar to DAC.

The alternate view is that technically you were calling this a debt discount as opposed to debt issuance cost. However, as accountants know, debt discount costs, unlike debt issuance costs, are netted against the liability. But again the SEC weighed in and said no matter what you call it, it goes through benefit expense. That's all we care about. So, at the last AcSEC meeting I think there was more support for the deferred asset presentation just because they wanted leave the liability more pure, more close to what the account balance is.

There is some detailed disclosure that would be required for sales inducements—what your policy is for capitalizing versus expensing, what types of bonuses you're deferring, and a reconciliation that shows your balance sheet amount. If it's buried in some asset, you actually have to spike out what your sales inducement balance is as well as the amortization for the period.

One of the issues that we've discussed for the last several meetings is the transition rules—not just for sales inducements but for the entire document. We're

dealing with a number of issues. It gets very complicated. Typically under GAAP, when you adopt a new standard, you do cumulative effect through the income statement. That's where you start. But there was some concern that for sales inducements this would involve a lot of work to have people go back and figure out what their inducements were for each period and whether they met our new criteria for capitalization, etc. So, there was an SOP that was issued related to some intangible costs that allowed people to freeze whatever deferred asset balance they had at the point of adoption. So we've gone with that tentative view where if you had expensed your sales inducements in the past, you would make no adjustment. If you had capitalized your sales inducements in the past, you would leave whatever amount was capitalized on your books at the date of adoption. Going forward, that would be a separate amount that you'd need to keep track of. You would basically amortize those deferred costs over the remaining estimated gross profits (EGPs) over the remaining life of the contract.

Any sales inducements incurred related to in-force contracts or new contracts after that date would follow the new rule in terms of meeting criteria to be able to capitalize them, and here's the amortization methodology, and for those you who would amortize over the entire period of the EGPs.

I should mention one last point on transition issues. This is just one of the areas. There are other topics we're dealing with in our project: separate account presentation, MGDBs, and GMIBs. When we drafted the transition guidance, it was rather complicated for AcSEC and for us. It took several meetings. The one comment that AcSEC had was that it seems like you're going cumulative effect for most of the things, but for this one you're doing prospective, and that doesn't necessarily make sense to us. Actually two of the AcSEC members dissented. We did a straw vote at AcSEC asking: Do you support this paper? What do you think overall? We're continuing to work on it and hoping to get it drafted and out as an exposure draft in September 2001. How many support it? Out of the 12 present at the meeting, 10 supported it and 2 did not. One reason why the two did not support it was transition guidance. They thought it was too cumbersome. They said just do cumulative effect for everything. What is this prospective for sales inducements? What's the point? So we may have some arguments with that.

Interestingly, the two dissenters objected to our views on GMIBs. GMIBs are another part of our project. After long deliberation and a very tight vote at AcSEC (eight to six) on that particular issue, we decided that the literature would not allow us to record the GMIB benefit in a direct contract. You cannot record a reserve for it, which I personally don't think is the right answer, but there's accounting guidance in *FAS 97*, which is quite clear that you don't consider annuitization options during the accumulation phase of the contract. The two dissenters also dissented from approving the SOP, because they just thought it didn't make sense. *FAS 133* also needs to be considered. So, if you have GMIBs, there is a specific DIG issue. The FASB's Derivative Implementation Group dealt with whether GMIBs are

actually embedded derivatives. For the most part, because a customer needs to annuitize to get that benefit, it would not meet the definition of net settlement under the FASB standard. So, for what I'll call the typical GMIB, that contract would not be a derivative, but there are exceptions. Some of these contracts are now available to cash out, I'm told, during the annuitization phase in a short period. I just wanted to point out that while our SOP says that under *FAS 97* you cannot record a liability, you still may have to for certain GMIBs under *FAS 133*. Secondly, we've also gotten a question about reinsurance of a GMIB. For the most part, from the way I understand those contracts work, there isn't a set net settlement between the reinsurer and the insurance company at the time annuitization is elected. So, if you are a direct company that has GMIBs, and you've also reinsured those, there's a good chance that your reinsurance contracts are derivatives.

As I said, we hope to get an exposure draft out by the fall, but we'll see how it goes with AcSEC. We've taken them through our conclusions now, and we're still in the drafting stages of our basis for conclusions. We will talk to them again in July 2001.

MR. DANIEL C. GIFFORD: The DAC on internal replacements task force that I work on with John is one that was really brought out to address issues relating to internal replacements that are not covered in *FAS 97*. In *FAS 97* it talks about internal replacements of traditional life contracts with universal life contracts, but it doesn't go much beyond that. As a result, there's a lot of diversity out there in practice for these uncovered internal replacements. There's clearly a need for definitive guidance because of the inconsistencies. Just sitting in the task force we've noticed the way different companies from the industry have handled internal replacements, and even the inconsistencies among companies depending on what the nature of those internal replacements are. In some companies, if they have a big program, they might track them, and if there are smaller things, they tend not to really look at those too hard. So there's some inconsistency from that standpoint.

Another reason that this comes up is that when Practice Bulletin 8 came out, it said that clearly *FAS 97* was not addressing other types of internal replacements other than those explicitly mentioned there. As a result, it leads you to believe that maybe there's need for further guidance. This is why this initiative got kicked off back in the second quarter of 1999. Currently, we're thinking of an initial presentation to AcSEC some time in the third quarter of 2001. In fact, John and I are headed to another task force meeting soon to start talking about what the actual SOP draft may look like. So we've got a lot of discussions, a lot of open issues. You'll notice as we proceed that a lot of this information is tentative. This is probably even more tentative than what Mary discussed, just because of the infant nature of our task force at this point. Our goal right now is to have a final SOP out in the second quarter 2003. That's obviously subject to change based on when we can get in front of the AcSEC and also get their concurrence on issues and tentative conclusions.

As we looked at it, we wondered if DAC should be carried over in any replacement transaction or should the *FAS 97* prohibition be extended? Practice Bulletin 8 pretty much answered that for us; they said internal replacements that are not covered in *FAS 97* explicitly should be dealt with on a case-by-case basis, and that was real clear guidance. So, that's one of the issues that we had. Other issues that we're trying to tackle: if carryover is permitted, does it extend to all internal replacements or is it limited to certain types of replacements? If it's limited, what are the criteria? We spent a lot of time with that. If carryover is prohibited, does the same principle apply to transactions that modify existing contract terms or substitute a new contract with only minor changes? Some people might say it's not an internal replacement; it's an exchange of contracts. What's the technical definition? We were unable to really draw a conclusion on that as a group. We're just really looking at it and saying, let's not get into that issue. We think that there's the opportunity to carry over, and we're going to get to which items that you include or exclude through some of the screens that we think are appropriate.

Some of the other questions are: if carryover is permitted, how do you determine the amount of old DAC to transfer? How does the transfer impact amortization of the remaining old DAC? How do the new acquisition costs get treated at the time of replacement? That's obviously a big issue from an industry perspective. If you've got new acquisition costs in this internal replacement, what are you going to do with them? Our view from an industry perspective is that we need to be able to capitalize that as new DAC. We'll talk about this in a little bit.

We envision the SOP coming out in a decision tree type format. We're going to determine whether or not to carry forward the DAC. Certain exclusions are being considered. Some things, like an addition of a fund option or a paid-up addition, don't even have to be tested. You can carry forward the DAC if it's pretty much benign to the contract. You're just adding new features that don't really change the economics other than creating some new fund options.

The first screen that we envisioned is really internal replacements that are dead. You come to the table, and you say what kind of internal replacement is it? Is it a *FAS 60* contract replaced by a *FAS 97* contract? If it is, you don't get to carry forward the DAC. If you've changed the benefit type (mortality, morbidity, and so on), those would be dead on arrival, and there's no carry forward of the DAC, and you don't have to go any further.

The second screen is more of a qualitative test consisting of seven questions. If you answer all seven questions with an affirmative reply, the contracts are virtually identical, and existing DAC should be carried forward. If you fail on any question, then you need to perform a quantitative assessment to see if the economics of the two contracts that you're replacing are essentially the same.

The qualitative test questions that are envisioned at this point include, is the sales transaction permissible, executed in accordance with the contract? This gets back to the question raised earlier regarding whether it is an exchange or a modification of the contract. We're trying to address that issue to some extent. Did you re-underwrite? If you had to re-underwrite it, it's not likely that it's the same contract or a very similar contract. If you've got substantially the same type of benefits being provided, then it's likely that you're still leaning toward a very similar contract. If the amounts of benefits, mortality, and expense charges remained unchanged, it's likely that you've got a very similar contract still, again assuming all the other questions have been answered affirmatively.

Was there any compensation to the agent or producer involved in this internal replacement? If you're paying for an internal replacement, then you've got to go show that the economics are still the same. Was there no deposit made to effect the transaction? Did it require additional deposits on behalf of the policyholder or the contract holder? Was there a change in account balance such as a bonus or a sales inducement type of credit that Mary was talking about?

Those are the initial screens that we're envisioning. If you can answer yes to all those, it's a substantially similar contract, and you're done at that point. You can go ahead and carry forward the DAC. John will discuss how we might calculate some of that. I think it's going to create a lot of opportunity for the actuaries in a lot of different ways.

The third screen is a catch-all screen, and if you failed on #2, you're not dead yet. You've still got a chance. The actuarial side is an assessment to measure the economic differences between the original replacement contracts. We're envisioning a tolerance threshold mechanism such as a 10% change in the economic value of the two contracts. We're also thinking that it's a single quantitative type of a test for all contracts—not a different type of test for different types of contracts. So, we're trying to make something that's pretty broad based, but we're also in the early stages of developing that. I think as John and I attend the next few meetings, some of that is going to become a little more clear to us all.

The general assumptions to use are the same assumptions that are used in the DAC model, except for those features that you change. So, if you're doing something that's changing the surrender rate, because the reason that you're putting this internal replacement activity in place is that you're trying to improve persistency, then you've probably got a change in the surrender rates assumption. There are probably other assumptions that changed, but anything that you didn't change between one contract and the other would remain static. You would do an analysis to see what the changes are. The substantial majority of assumptions should be similar between the two.

One of the issues that we're still wrestling with is the amount of DAC to be carried forward. Right now it's likely to be based on a percentage of the block that moves, and it'd be measured on a periodic basis to see how much of the existing block would move. New assumptions may be required for components of old DAC as you move them into the new block. There are also the additional costs at replacement. Defer and amortize those based on existing guidance, which from an industry perspective, is clearly where they were leaning. The amortization period we're looking at on this carry forward DAC would be consistent with the type of contract that it is, so expected life of the book of the contracts for *FAS 97* products and life of the new contract for an *FAS 60* contract.

As far as the next steps, the task force plans to present preliminary findings and issues to AcSEC more in an informational setting in the third quarter 2001. As I said before, we haven't really presented any of this, so nothing's been approved, rejected, or reviewed by AcSEC. So, obviously all this is subject to change, but it's certainly the latest information we can give you at this point.

MR. JOHN W. MORRIS: As Dan mentioned, he and I are part of the AICPA task force on DAC for internal replacements. I am the representative of the American Academy of Actuaries through my involvement with the committee on life insurance financial reporting (COLIFR). So I'm very interested in receiving comments from accountants or actuaries, but mostly making sure that the actuarial concerns are represented in our committee. We're very anxious to receive information on what everyone's thinking before we get too far down the road.

I want to make sure you understood that material being presented from the internal replacement side is all still in the discussion stage. No decisions have been made and we haven't met with AcSEC. Don't take anything that we say as being GAAP guidance. It's not.

I'll give a brief history for those that haven't been following this issue. The AICPA did release a discussion paper in June 1999 that essentially said, here are the three ways you could treat DAC for internal replacement: you never carry over DAC, you always carry over DAC, or you sometimes carry over DAC. In the 11 response letters, none of these views got an overwhelming majority.

In trying to deal with DAC for internal replacements, we weren't quite sure where to start. We decided to concentrate on formal replacement programs, and we have not yet defined exactly what that means. Our initial thought was that agent replacements may be immaterial, but after talking to a few people I don't necessarily agree with that aspect anymore. I've talked to a few companies where there is a material amount of replacement that would not fall under our formal replacement definition, if we ever have one.

Dan mentioned some of the existing guidance of FAS 97. We talked about benefit types. If you're replacing mortality with morbidity or long duration with short duration, they would be dead on arrival. I don't think there's any place in GAAP where it says that you can't do that, but that seems to be the underlying principle of GAAP that we're following in our discussions.

We don't expect many of the contracts to pass the seven screens that Dan discussed. We figure 99% will need to go to the quantitative test. How do you even perform the quantitative test? You don't do it on a policy-by-policy basis. We envision doing it on a block of business, and that creates a lot of issues for actuaries. If you're replacing several types of variable annuity products with your new variable annuity products, do you test each specific policy form or do you test a group of policy forms? How does that work? We haven't come to a conclusion one way or another.

The other thing that you have to keep in mind is that when you're testing, you're probably testing a lot of contracts that are in different durations, and so the economics would be different. We haven't talked about testing each duration. It's more a test of a group of contracts, and if they pass the test, then you're fine. We've done a little bit of modeling on this but not extensive modeling. So, if there are areas out there that you think we're missing, we'd like to understand what they are.

When do you apply the test? We thought you would apply the test as of the first day of a formal replacement program. Again, we're concentrating on just a formal replacement program. This will eventually apply to other types of replacements, and that'll be an issue we need to address. We're thinking about what happens if your replacement program runs indefinitely. Do you test once and then you're done forever, or would you have to retest? We thought an annual test might make sense. We also thought if you test assuming there's 100% conversion—because you're really just testing to see whether a policy converts or if a group of policies convert, whether that would qualify as a replacement.

When we got down to the test, we tried to figure out what to test. Our conclusions were basically that you should use the underlying stream of what the DAC amortization is going to be based on. So, for *FAS 97*, it was EGPs. In *FAS 120*, EGMs. We haven't spent a lot of time on *FAS 60*, but I presume it would be premium. But just looking at EGPs or EGMs by themselves, I don't think gives the true picture of the economics. You need to include the new acquisition costs and any new front-end loads that would not be part of your EGPs or your EGMs in the present value basis. Then to do the present value, our initial thought is that you should use the GAAP discount rate (which would be the crediting rate under *FAS 97*, and on *FAS 120* and *FAS 160*, it would be the earned rate). You'll be doing present values as of the issue date of the new contract. We ought to think about taking present values as of a date in time for the new contract that's signed because

that's from the date of issue of the new contract. But for the old contract, you're sort of picking up in the middle—possibly durations five or six, or wherever that policy is, and going forward. So, we envision a test where you start with the issue of the new contract and look at the present value of that compared to what the old contract has remaining. So you'll miss the first few years of the old contract in the present values, and you're looking at what cash flows are being replaced with the new contract.

As Dan mentioned, we talked about the same assumptions that are less affected by replacement, and we haven't fine tuned this. In some of the modeling we did, where the replacement improved crediting rate by lowering an investment spread, we thought it was appropriate to modify your lapse assumptions because that would be affected by the replacement contract's enhanced benefits. So, things like that are still not fine tuned as far as exactly what you can change and what you can't. But clearly any assumptions that are unaffected by the replacement should not change when you're doing your present value comparison.

We've been throwing around a 10% threshold for the test that Dan mentioned. There is some guidance in GAAP with regard to non-insurance replacements—if cash flows are within 10% of the old cash flows, then it's a substantially similar contract. So, we're still caught using that. I guess it's a placeholder, but it may end up being more than just a placeholder—it may result in some non-intuitive conclusion, but I think additional modeling will tell.

An example of what you'd be comparing are the EGPs that the new contract would generate. There are provisions for new front-end loads and new acquisition costs so that what I call the adjusted EGPs are the new EGPs plus any new front-end loads minus any new acquisition costs. You compare that with the original EGPs and do the present value.

The other thing I wanted to point out is that if you do this test and if new EGPs are more than 10% different than the old ones, but you want to carry over the DAC, do you then go back and say, maybe I really need to pay my agent just to get the proper GAAP accounting? There are some issues like that which we haven't fully dealt with, but we at least are studying them. Again, we would like any input that anybody has, particularly if your company has instituted any procedures of their own that seem to be working with regard to DAC replacements.

How much DAC do you carry over? There are other issues that we need to deal with in addition to any new DAC that's generated by new costs that you incur for issuing new contracts. We haven't focused on what you do with any unearned revenue reserve (for example, FAS 97 limited pay contract), and we haven't talked about what to do with the difference between the old surrender benefit that you transfer over to the new contract and what the new benefit reserve would be. These are issues that are still on the table.

But how much DAC to carry over? For *FAS 60*, it should be fairly easy because DAC is often calculated on a policy-by-policy basis. So, we're not as concerned about figuring out how much DAC you apply to the contracts that convert, and it's generally fairly intuitive what is applied on *FAS 60* products. For *FAS 97*, regarding EGPs and EGMs, you generally don't have DAC that's allocated down at the policy level. It's generally a DAC that's applied to a group of policies. So our initial thoughts were to take the DAC you have immediately prior to any replacement or conversion and split it between those policies that converted and those that didn't, so that the sum of the two equals what you started with.

I don't know how much guidance we'll wind up giving. My guess is that this would be left up to the actuaries to determine how to make the split. Let's discuss an example that we've been talking about in some of our subgroups. It's a five-year product, and to keep interest rates from messing up the calculation, we had \$100 of EGPs each year with a \$200 initial DAC that gets run off linearly because of no interest at a 40% DAC amortization ratio. So, at the end of year three, that's when we're going to assume that you had a replacement. The example would have \$80 in DAC.

In the first example let's assume that 90% of the people did not convert, and 10% of the people converted. Then you would determine that the EGP gets split 90/10, and that may not be that easy. I mean, how much EGP is split? Do you split it based on account value? If it's a universal life (UL) product, do you split it based on face amount or some combination? Again, we're not far enough along to know the best answer, whether to give guidance or whether to leave it up to the actuary to determine the best way of splitting it.

For this example, it's pretty straightforward. Everything gets split 90% to non-converted, and going forward you would end up with \$72 of DAC at the end of the third period, and that would just continue to amortize business as usual. For the converted policies, the \$8 at the end of year three would then go probably to a new amortization schedule combined with any new DAC that gets generated and would amortize based on a new schedule with the assumptions of the new converted policy.

We also talked about what happens if the actuary thinks that the future EGPs aren't linear—if it isn't split 90/10. For an example of this, I had non-converted policies getting \$95 and the converted policies only getting \$5 of future EGPs. First of all what you realize is that we lost \$0.65 in DAC somewhere because we're at \$74.35 rollover DAC in year three which is less than the \$80, but that's the way the math works out. I've checked it a couple of times. What we were thinking for the non-converted policies is that the \$74.35 would then be amortized as usual, and the difference between what you started with (the \$80) and the \$74.35 is what you

would bring over to carry over. But, again, this is a very simplistic model and probably doesn't reveal all the pitfalls of trying to split the EGPs.

I know a lot of people have difficulty in determining historically what EGPs would apply to converted policies and non-converted policies. But these are the types of things that we're trying to study.

MR. ROD L. BUBKE: Our company has historically offered fixed annuities and fixed universal life and recently has begun offering variable products. We've handled internal replacements differently. UL to variable universal life (VUL)—the product is basically the same, we are just giving the policyholder access to the subaccounts. In that instance we've carried over the DAC, and the amount carried over has been based on face amount. Future EGPs in the UL business have been reduced by the amount of face amount carried over or transferred. On the annuity side, we haven't carried over the DAC because the products are different—a different charge structure, obviously surrender charges are different, and the interest spread and M&E charges are different. So we've handled it differently, and we've taken viewpoint C—sometimes you do, and sometimes you don't.

MR. GIFFORD: That's consistent with the views that have been shared by others in the industry—they've taken it on a case-by-case basis, similar to what Practice Bulletin 8 said. Internal replacements that aren't specifically addressed in *FAS 97* are evaluated on a case-by-case basis. But it's our understanding in the industry that there are other companies that would look at all of those internal replacements as able to be carried over and others that say none of that is able to be. That's exactly why we're trying to address that. What you're doing is somewhat intuitive and similar to the way that we're looking at it. To the extent that it's a very similar contract, it sounds like you're carrying forward the DAC. For those that aren't, it sounds like you're letting that run through the model as a lapse, if you will. The structure that we're putting in place hopefully just levels the playing field so that everybody's doing the same thing—so there is more comparability between different companies' financials.

MR. MORRIS: I wanted to mention that we're looking at the economics in doing the EGPs and the present values. Basically, are the contracts being replaced with similar contracts? Neither Dan nor I put in our presentation what happens when going from the general account product to a separate account product. Even if the economics are exactly the same, we're not sure how to handle that when the investment risk in particular has transferred from the company to the policyholder, and can you call those substantially similar contracts or not? We don't have any conclusions at this point.

MR. WILLIAM R. ALBRIGHT: Mary, I was wondering how you would treat a bonus if a company is paying a bonus at annuitization. For example, if your annuitization option was a non-life contingent option, and you are using the

constant yield method to determine an interest rate to calculate the net GAAP liability, would you reflect the bonus in calculating that interest rate?

MS. SASLOW: I would refer to that as an annuitization option, and under our tentative conclusions, since it's an annuitization option, you would not be able to record that amount in the accumulation phase of the contract. That would be the tentative conclusion based on the *FAS 97* guidance that says that annuitization options are separate elections by contract holders that cannot be accounted for until the new contract is actually put in place.

MR. ALBRIGHT: I guess I was asking what you do at the time that you annuitize with the bonus.

MS. SASLOW: That amount would be part of your existing balance. Whatever your account balance is would be rolled in as the premium that was paid for the annuitization benefit. Is it life contingent or period certain?

MR. ALBRIGHT: Well, it could be either, but I was thinking about the non-life contingent or just period certain.

MS. SASLOW: If it were period certain, then technically under GAAP you don't have an insurance contract. You just have a payout. You would take the difference between the premium, i.e., the account balance that you're transferring over versus the future value of those benefits, including the annuitization option and solve for the internal rate of return on that. That's how you would amortize that over the period, accrete to that, if you will. It would be like a debt model basically.

MR. ALBRIGHT: So, the bonus would be included. In the case I'm talking about, you would be adding 1% to the account value as you rolled it over to annuitization.

MS. SASLOW: But that 1% would really be in the form of payouts in the annuity phase. So those would represent your future payout. Then you'd solve for the interest rate. That's the way it would work on a non-life contingent, on a period certain, and on a life contingent I guess then that would become an insurance contract. You'd have to record the reserve using a discount rate. The discount rate would be based on the current earnings rate. In which case you could end up in the insurance model potentially having a premium deficiency depending on when you discounted that amount if it was more or less than the premium that you paid. That's the problem with the investment contract model when it's pure debt. You don't take an immediate write-off even if you're getting this premium then, and you're paying out this significant benefit. Basically you'd be taking those losses over the period of the payout annuity as the difference between what your investment yield is earning and what your annuitization expense is.

MR. ALBRIGHT: But that still has the effect of deferring the expense over the life of the annuitization, right?

MS. SASLOW: Yes.

MR. THOMAS J. YEFCHAK: We sell a variable universal life product which has a 90 basis point M&E charge. However, in policy durations 11 and later we have a 50 basis point bonus which is not guaranteed, but, of course, we intend to pay it. My question is a clarification of the first discussion—would it be most appropriate to have 90 basis points M&E in the EGPs and then set up a liability for the bonus in duration 11 or could you have 40 basis points in the EGPs and then set up an unearned revenue of 50 basis points in the first 10 policy years? Are those equivalent or would one be preferred over the other?

MS. SASLOW: Would the terms of the contract identify that amount of the bonus? The quick answer is you have to meet the criteria of (1) identifying that amount as a bonus in the contract, and (2) proving that that amount was an increase to what typically would be an amount that you'd pay on that contract versus other contracts, if it's an incremental amount. Over what period would this incremental amount be?

MR. YEFCHAK: The bonus would be payable for all policy years after the 10th policy year.

MS. SASLOW: The bonus would be paid to anyone persisting after the 10th policy year?

MR. YEFCHAK: Right. So, effectively you'd have an M&E which really reduces to 40 basis points net after the 10th policy year. So, the effective M&E charge is really 40 basis points after the first 10 years—but, of course, it's a 90 basis point M&E. My question is really what should go into EGPs, 90 or 40?

MS. SASLOW: Well, now you said it's really part of your M&E fee as opposed to an identified bonus amount.

MR. YEFCHAK: Well, the bonus would be if you persist to the 10th policy year, then you'll receive a credit of 50 basis points on your account value after the 10th policy year. So, effectively your M&E reduces down to 40.

MS. SASLOW: So, the basic M&E is 40, and you have that additional 50. Is that what you're saying?

MR. YEFCHAK: The M&E is 90, but the bonus is 50 payable to the policyowner.

MS. SASLOW: I don't know. I guess I'd have to compare it to what your other products were doing and whether that was just a way of changing the M&E structure, whether that was truly a bonus versus what your other M&E fees were on other similar products.

MR. KLEIMAN: Isn't part of the issue that he's saying it's non-guaranteed, but it has to be in the contract?

MS. SASLOW: What do you mean it's non-guaranteed? It's not a contractual payment that you're required to make?

MR. YEFCHAK: No, it would be a best estimate that we would intend to make the payment.

MS. SASLOW: I agree with you. It's not contractual. It wouldn't even meet the first criteria. The amount that you were going to pay would have to be specifically stated in the contract.

MR. YEFCHAK: Well, I believe it is but just not guaranteed.

MS. SASLOW: I'm not sure I understand what that means.

MR. KLEIMAN: Well, it means it could be 50 or it could be 10, is what you're saying?

MS. SASLOW: Well, then that's not contractual.

MR. ALLAN W. RYAN: I think the question that was just asked has already been covered in the accounting literature. Isn't this really an unearned revenue? If you have M&Es that are higher in early years you would accrue.

It's similar to mortality charges that are level or that are not equivalent to the charges actually being incurred. So, I don't think that even comes under sales inducements. Does anyone know?

It's not really a sales inducement. It's just unearned revenue.

MR. KLEIMAN: Well, I think it's the form of the contract that I was even puzzled by. Is it really saying your charge is 90, and then we'll offset 50 of it or is it just it's 90, but you might get 50 basis points in the 10th year? If it's phrased that way, then they are two distinct things and not offsets.

MR. RYAN: It doesn't matter whether it's guaranteed or not. It's just a matter of your best estimate is you're going to charge 90, and then you're going to reduce it.

So you could treat the M&E charges you collect in the first 10 years as unearned revenue.

MS. SASLOW: No, that's a good point. You could look at it that way, but that's basically what the contract says as well. It's structured as an M&E.

MR. RYAN: If it's not really material, maybe you don't do anything.

MS. SASLOW: Right. People vary on what the time period is.

MR. RYAN: It's like mortality charges that are constant or that don't really relate to the charges for the period being collected.

MS. SASLOW: My understanding is there's diversity in practice on that issue, as to whether you set that up or not.

MR. RONALD L. STOPHER: I have a question about the quantitative test. If we want to take a management action to improve persistency on an existing block of FAS 97 contracts, and we work through the quantitative test and it's beneath the 10% threshold, and then, say, two years from now we do some other slightly different upgrade programs to the same block, do we have to take into account the fact that we already have one program? Is there any interrelationship between two separate upgrade programs, each of which on their own would pass the 10% quantitative test?

MR. MORRIS: Can you just clarify a little bit? Are you saying you did a replacement program, and it did or did not pass?

MR. STOPHER: Let's say it's an upgrade program, same contracts. Let's suppose that we had SEC exemptive relief to reimpose surrender charges if we pay a credit to the contract. So, the policyholder is offered this, accepts it, and we do this to a block of contracts. The result is that it's less than 10% across the block. That program finishes, and then, say, two years later we do another upgrade program to the same block.

MR. MORRIS: Well, you're saying in the first example it passed, and you carried over the DAC and you essentially started a new amortization schedule with new EGPs, and then a year later you have another replacement program. You do a test with the EGPs of the first replacement, is the way I would view it. It's the only thing you have to compare with, if I understand it right. Let's take the example where everyone took that first replacement. Then the only EGPs you have are the ones from the new contract at that point, and then I think you compare that with your second replacement EGPs.

MR. STOPHER: So each time you make the comparison you compare it with the current series of EGPs.

MR. GIFFORD: I think that's correct, and maybe I'm reading more into your question than is there. But your goal is to get to the second replacement, but the second replacement product compared to the original product would fail the 10%. Is that the question?

MR STOPHER: I think that's an implication of the question, yes.

MR. GIFFORD: Okay. We certainly haven't addressed that issue, but now we will. But to John's point. I think because you replaced the contract once, now your baseline is the new contract. Now, clearly we've not talked at all about whether the contract has been replaced once, and you're in the first year or two, we haven't even thought about that. I don't think you can go back and redo it, but there may be something to look at on that. But under current thought, you'd take that second replacement and compare it to the first replacement, not to the original contract because you've reset the amortization schedules.