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Summary: Panelists address recent, current, and proposed activity in the life insurance company financial reporting environment. This session provides updates on a number of GAAP, statutory, tax and international financial reporting issues.

MR. JOHN F. BEVACQUA: Let me introduce some of my co-panelists. First, Daryl Boltz, works within the corporate actuarial department at Mass Mutual. His primary responsibilities include mergers and acquisitions, international matters, and general corporate oversight in the financial/actuarial area. Prior to joining Mass Mutual, he was a life actuary for Hartford International responsible for many of its European operations. Daryl recently worked on the purchase accounting for Mass Mutual's recent acquisitions in Japan and Taiwan.

Also presenting will be Alastair Longley-Cook. Alastair has worked for Aetna for 28 years. He's been very active with many of the Society meetings and has spoken in many sessions. He's currently working at Tillinghast and is also chairing the American Academy of Actuaries' Life Capital Adequacy Subcommittee, focusing on risk-based capital (RBC) standards.

We're going to start off with Alastair, who's going to talk about international accounting standards, fair value of insurance liabilities, codification and some

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Note: The chart(s) referred to in the text can be found at the end of the manuscript.

activities relative to the NAIC's enhanced regulatory risk assessment framework that's currently underway.

MR. ALASTAIR G. LONGLEY-COOK: I'd like to remind you that this is an open forum. It should be pretty informal; if you have a question or comment, just speak up.

The international accounting standards is, perhaps, a good way to start out to talk about what's going on in the international arena. But, perhaps, most of us are more interested in what's going on with the NAIC, and we'll spend a little more time on that and fair value, which is more of an international trend, but something we'll be seeing more here in this country at some point. Codification I'm going to discuss very briefly.

What's driving the international reporting standards is the consolidation of financial services throughout the world and the globalization of many companies. Many of you work for multinationals or consult for the multinationals. The diversity of the current practice in every country' can be pretty frustrating, and it's difficult to have standards that people can understand if you're listing, for instance, on one of the international stock exchanges. The International Accounting Standards Board (IASB) is the organization trying to pull together a response to this problem and develop global accounting standards. These are scheduled to be required in Europe in 2005. What they have promulgated is a draft statement of position (DSOP), which you can access on their Web site: http://www.ias.org.uk.

Defining an insurance contract is 'not something I'm going to get into, but it is not an inconsequential issue. We need to be able to figure out just what comes under the auspices of these requirements and what doesn't. Risk must be material, for instance, to qualify.

Another issue is that the accounting should be entity specific. It doesn't matter whether the insurance policy is issued by a bank or insurance company. The issue is, what is the entity that is being accounted for? Unlike what we're used to in the GAAP standards, there is no requirement for matching of revenues and expenses, hence there is no deferred acquisition cost (DAC), and that is either good or bad depending upon how fond you are of DAC.

One of the items that differs, certainly, from statutory reporting in this country is the absence of explicit margins. Another is that current estimates should be tied to market assumptions, and those that are not attainable from the market — for instance, mortality — would be based on current management forecasts. The same is true with expenses.

Reflection of risk is a very big issue, and I'm going to keep coming back to this again and again. They recognize that we're not talking about just normal assets and liabilities that don't have significant risk elements to them. There are several ways you can reflect risk in a value that you're putting on a balance sheet; one is to adjust the cash flows, another would be to adjust the probabilities, and a third would be to reflect it in the discount rate. They're talking about all three. They use observable market data, if possible, and I'll come back to that on fair value. We don't have market data here.

But the fourth bullet is very important and comes into the issue of fair-value accounting as well: using option pricing models to reflect embedded options. We, as actuaries in this country, I would say do not use option pricing models. Currently, the work that my committee is doing on RBC standards for variable products with guarantees is basing those standards on what we would call realistic stochastic projections.

A financial theorist working in the banking or trading area would never do that. He or she would base the price on option, on arbitrage-free, interest rate pass, for instance, which is a process where you basically replicate the cash flows or whatever you're trying to price with cash flows in the market that has a price. You then can get the adjustment to get you the price you're looking for.

That is not a standard practice that we use, and that's going to cause some problems as this goes forward if that's the way those calculations have to be done. I'll return to that in the fair-value discussion.

One of the next steps is the DSOP. Your company may, indeed, be involved in commenting on it, or you may be involved in some of the other committees that are working with the IASB or the Academy. There's a fair amount of discussion going back and forth, and the exposure draft release is planned for late-2002.

Let's move into fair value, which is something you may have heard about. It is part of this international discussion. It may or may not be implemented in tandem with it, and it may or may not be embraced by the United States accounting standards boards like FASB. But it's something that we should be aware of. It is indicative of the trend in accounting worldwide that, if you're not aware of, you would do well to pay some attention to, although it is an area that 'has a ways to go before we will see it.

Again, there are similar kinds of drivers pushing for it. But what the market analysts would like to have, in a nutshell, is an understanding of what the value is, particularly of the liabilities, on a fair-value basis. That's not quite the same as market value because there is no market value for insurance liabilities.

The definition of fair value is "whatever somebody would sell it for in a free trade without pressure." So it's a market price even though there is no market necessarily at the moment. 'There has been this trend toward market valuing assets and liabilities in a lot of industries, and this is part and parcel of it. The kinds of book values that are set by GAAP standards become less and less satisfactory, particularly for market analysts who want to understand what this is really worth. So that's desire. The big question is, can we get there?

There are different accounting initiatives that are very similar to fair value. They're not really fair value. We've already talked about international accounting'. Embedded value accounting many of you may be familiar with. This is the embedded value in your insurance policies that are in force. They're generally calculated as the present value of distributable earnings. That's free cash flows after provision for reserves and required surplus. The discount you use to determine present value it is a debatable item, but most calculations would use a hurdle rate that the investor is looking for to discount those cash flows. So, is that fair value? Is that market value? It's clearly not market value because most companies, if they are sold, sell for one and a half or two times embedded value, particularly in Europe. But it's at least an attempt by actuaries to get at the value of the in force. It does not capture the goodwill, the value of future sales, for instance.

Internal management reporting is another initiative. We got introduced to it about 10 years ago. A lot of companies use it internally to understand where their earnings are coming from and whether or not blocks of policies are adding value or subtracting value because, once you look at the change in embedded value, you want to compare that to your cost of capital and see whether or not you're covering it.

Mergers and acquisitions is another one. The appraisal value would be similar to embedded value plus some provision for sales, but not quite necessarily the fair value. FAS 141-142 was just introduced to make sure that the goodwill is recoverable. It requires the same type of thing.

The definition of current market price is "the price that a knowledgeable, willing buyer would pay to a seller for a specified asset."

FROM THE FLOOR: You mentioned that typically market value is about one and a half to two times embedded value. Are there some companies that are trying to do embedded value to include the value of potential new business, the value of the field force, etc., in which they wouldn't get fair value?

MR. LONGLEY-COOK: Yes, they're trying to get at that by, say, throwing in 5-10 years of future sales into the calculation. What you use there is fairly judgmental. But, yes, there are attempts to go from embedded value to a fair value or even a market value, particularly when you get into a merger and acquisition activity. And that would be the way to do it. It's just usually somewhere around five or eight years; something like that might be a conservative additional value. But the value you discount that at is very sensitive to those assumptions so you have to be careful.

FROM THE FLOOR: One of the challenges I'm facing on the fair-value issue is that fair value follows the definition used for assets. The liability you can leave as a negative asset. But there is no way you can sell a liability. Could you comment on that?

MR. LONGLEY-COOK: Yes, this is one of the very controversial issues within this fair-value discussion that's going on. There's an Academy task force chaired by Burton Jay that has been dealing with this issue now for well over a year. I was on it. I literally had to beg to get off because I was getting 50 e-mails a day from the task force going back and forth'. And one of those issues is exactly the one that you raised: It's very, very difficult to literally sell a liability. Typically, from a legal standpoint, unless you buy the whole company—which is a different issue because that's got all the assets and the bricks and mortar—you don't sell a lot of insurance liability, you reinsure it. Unless it's a coinsurance-type arrangement, then the primary liability remains with the ceding company.

The key issue here then becomes the fact that there is no market value for an insurance liability to which one can true up to option pricing methodology, either because of the legal or other issues. You just can't open the *Wall Street Journal* and go to page C5 and say, "Here's a whole list of different insurance liabilities I can buy, and here's the price." It doesn't exist. Usually you have some negotiating between buyer and seller, maybe a couple of buyers bidding, and who knows what drives it? Perhaps it's expense synergies. And without that yardstick, option pricing fails because you don't have anything to true it up to. In option pricing, you basically come up with probabilities that are not real probabilities, but they are the probabilities that bring you to that known value. Then you can use those probabilities to calculate some other value. You can't do that with liabilities.

But option pricing is the mindset of everybody on the other side of this debate — the accountants, the finance theorists, 'etc. We, as actuaries, shake our heads and say, "It doesn't work here," and that's where we're bogged down. It's like we're speaking French and they're speaking Italian. It just doesn't go anywhere.

A couple of ways to get it is either to calculate directly or calculate the total value of the assets and subtract the surplus. Either way you have problems.

We have talked about the availability of market information and, again, the inclusion of a provision for risk. Another basic tenet of finance theory pricing is that you basically price everything at a risk-free rate. You take these cash flows and plug them through risk-free rates. You plug in risk-free rates, and then you make your adjustments for risk after that, but everything is done based on arbitrage-free, risk-free rates.

Think for a moment if you were trying to calculate the fair value of a GIC. So you have your assets and you have the GIC. And the GIC is one where there is no risk in the liabilities. There's obviously asset-liability mismatch risk, but the liability has no other guarantees other than the fact that if you give me $10 million now, I'll give it back to you plus 8 percent interest after five years. Bang, that's it. If you price that using an interest-free discount rate, every time the insurance company sold a GIC, it would have a loss immediately on the books because you're discounting that liability at interest rates far lower than you're discounting the assets back in the GIC. Even if it's perfectly matched, you have a loss.

The finance theorists and the accountants say, "Well, I guess that's the way it is. Maybe you guys aren't pricing these GICs right." And we say, "No, we've been doing it for years and it seems to work." That's the way the discussion goes 'and the kind of quandary we're in. If you want to join the discussion and receive 50 e-mails a day, give Burton Jay a call.

'We have a draft, but a big question is whether FASB will embrace us or not. My guess is they won't want to touch it with a 10-foot pole, but if the rest of the world goes this way, well, maybe they'll have to.
I'm going to spend very little time on codification, 'because is it tedious. For your interest, 'there are two things going on' that tie in with the rest of the discussion: (1) deferred tax assets and liabilities, which has been a big issue that has now been accepted, except in New York; and (2) the RBC standards, in which changes to the deferred asset and liability portions of it were implemented, which meant that the RBC standards actually dropped as a result, which is nice.

'The fourth issue that I want to talk about is the change in the NAIC thinking around risk analysis. The mover of this change is the risk classification subgroup of the Financial Reporting Working Group. It is charged with rethinking the way the NAIC does its examinations, particularly with regard to how it analyzes risk in an insurance company.

The drivers are the same ones. That's the common thread through all four of these topics. And what's driving this is the globalization convergence complexity of both the assets and the liabilities, the ability for us to do things with computers and software that we couldn't do even 10 years ago, and banking sector initiatives.

You may be familiar with Basel 1 and 2. These two accords were specifically aimed at improving regulation of banks. The basic conclusion of Basel — which is not a regulatory body, but basically establishes the standards for worldwide banking regulation — was to put far more initiative on the banks to have an effective risk management program, convince the regulators of it and take credit for it in their capital standards to the extent that they could do so.

The NAIC is moving in a very similar direction. In the past, the way this has been handled is through a combination of examinations and capital standards. The capital standards, up until recently, have been formulaic: If you have this much of that type of bond, this is a factor. As the products got more complex, as the assets and liabilities became more interwoven, and after a few companies failed even though those factors were applied, the NAIC realized that that's not going to do it anymore, just as the banking industry realized that' is going to do it. They realized that you really need to dig behind and find out what that specific asset and liability structure is and how it behaves in different scenarios.

Charts 1 and 2 show the goals and the risk classes, respectively, that NAIC has identified. 'What's remarkable about the NAIC's list of risk classes is that the last four are a little surprising. In fact, I would characterize all four of those as operational risks.

One of the big issues under Basel 2 was the setting of capital standards for banks for operational risks. And, again, the bank can get credit off the formula if they can convince the regulators that they are managing operational risk well and have a good track record.

What' is operational risk? It's just about anything that we actuaries don't know how to model, which makes it very difficult for us to come up with quantification. It's capital standards, monitoring and controls.

The first four risks we're pretty comfortable with. Maybe we don't spend that much time in credit, but, certainly, nowadays it is important. In the market, pricing/underwriting and reserving, we always have. Liquidity is something that's more asset-liability intertwined, but still one that we can hold our own on.

Once we get into operational, legal, strategic, and reputational, we're into some pretty soft, fuzzy ground. But this is where the NAIC 'and Basel are focusing because, if you look at the monumental failures, just about all have been operational risk failures. They show up as financial failures, but start out as operational failures, what we used to call C4.'

The tools that the NAIC is using is what I'd call a risk profile (see Chart 3). They talk about an insured profile form. So it's going in and analyzing the risks very much more internally as opposed to externally. What they basically did in the past was send in a team of examiners that basically just checked that you followed the rules right. It would be, "Did you follow this particular requirement?" and "Show me." Well, that's an auditing function, and all of the companies being examined have auditors already doing that. So the NAIC said, "We don't need to do that, too. We'll rely on the outside auditor to make sure they're following some particular reserve standard or some particular reporting standard. We'll leave that to them. What we'll do is train our examiners to go in there and get behind that and find out where the risks really lie."

Currently, my firm is helping the New York State Insurance Department do exactly that for a new department they've created called the Capital Markets Risk

Department, which basically is charged with No. 2 on the NAIC list, but it ends up involving a lot of other ones as well. They want to have examiners go in and find out just exactly what is your exposure out in the tails to those guarantees you have behind your variable products.

'This seems to be a lot of different stuff, but it has a common theme that maybe I can pull together. You' have increasing globalization, convergence around the world with all these different standards, and in this country with 50 states, that all need to be pulled together so that we're saying something with some kind of commonality to Wall Street, the rating agencies or the regulators. In today's world, where you have extremely complex assets and liabilities, where the risk is not in the middle of the distribution 'but way out on percentile 99, a simple value-at-risk or simple sensitivity of 10 percent up/10 percent down isn't going to do it. You have to find out what's going to happen out there in the 90^{th} conditional tail expectation'.

There's only one way to do it. You have to go inside the company and have the company run some models. Then the examiner or the regulator can evaluate it and see whether or not the company has a good handle on those risks and has the right mitigation in place to manage it. If not, you need more capital or you need to change your products.

MR. BEVACQUA: We're now going to switch over to Daryl Boltz, who will give us a brief overview on some of the activity that's been taking place over the past year on purchase accounting, which is more or less referred to as FAS 141 and 142. Working from a practitioner's perspective, he can tell us about the challenges that he' has faced in terms of applying some of these standards to the transactions that Mass Mutual has been involved with.

MR. DARYL L. BOLTZ: I'll be talking about the recent purchase accounting changes according to FAS 141-142. Prior to this, for more than 20 years, this area has been governed by Actuarial Practices Bulletin (APB) 16 and APB 17.

Let's look at the major changes of FAS 141. Purchase accounting now must be used for all acquisitions after June 30, 2001. Pooling is gone, so in the case of a merger, more specific guidance needs to be provided on how to determine exactly who the accounting acquirer really is. Also, another change is that specific criteria are provided for recognizing intangible assets apart from goodwill. Unamortized goodwill must be written off immediately as an extraordinary gain. Prior to this, it used to be amortized into income. Additional financial disclosures regarding business combinations are also required.

Regarding the mergers, in determining whom the accounting acquirer is, it's the larger entity or the one issuing equity. It's also affected by voting rights and management control agreements as well.

Intangibles apart from goodwill are defined as "those of rising from a contractual or legal obligation." Examples here would include trademarks and patents. A second type, which are not legally or contractually bound, are those that are separable. They can be sold, rented or licensed. A good example is a customer list. The general intent of the intangibles apart from goodwill under the new rules is to have more of these and less goodwill under the new rules.

There's a whole list of additional disclosure information required under 141 and 142. One is more information about the acquisition, such as the name of the company, the reason for acquiring cost, a condensed balance sheet, 'and information about the goodwill and intangible assets that weren't required before. I won't get into those now.

FAS 142 provided significant changes from APB 17. The big one is the goodwill and intangible assets. There's no longer a requirement to amortize these. In the past, this caused big earnings hits as to any acquisitions that were done. So this was welcomed by the companies like ours that do acquisitions. The amortization period for finite intangible assets is no longer limited to 40 years, but really to the life of that asset? And finally, there are additional disclosures as well for 142. The key one is intangible assets. You need to determine what the amount is, any residual value there may be, and a weighted average amortization period. These three things need to be disclosed.

Let's talk a little bit about impairment issues. An impairment test must be performed at least annually and possibly in between if there is any significant change in the company. These could be due to legal, regulatory or competitive reasons. There are some transition rules with regard to goodwill. If you had an acquisition under the old rules and you're moving to the new rules after the effective date, an impairment test must be performed within six months of adopting the new rules. Impairments within the six months are classified as an accounting change, which happens below the core income line. But any impairments that you take after the six months would hit the operating income. This provides a final window of opportunity to clean up any problem investments you may have out there, but that window is closing probably for most companies in another 31 days.

Chart 4 compares and contrasts intangible assets. There' are two types. There are the indefinite ones, which are assumed to continue indefinitely, and 'the finite intangible assets. The key thing you need to know is that, in the indefinite one, there' is no legal, regulatory, contractual, economic or other limiting factor, which may make it not as valuable some years hence.

If it doesn't meet that definition, then it's a finite intangible asset. As far as amortization, there's no amortization for the indefinite intangible asset as long as it remains an indefinite asset. You may find a couple years hence that this asset is no longer an indefinite one, but a finite one. Amortization of the finite ones' is in proportion to the use or cash flows generated from that asset. When these cash flows are used, if it's not known when you set up the schedule, a straight-line amortization can be used.

As for the goodwill impairment test, I think step two in Chart 5 'can be a little confusing. ''To illustrate how step two works, suppose we have a single company, and this company has two reporting units. The reporting units are typically what we call the operating segments, and they could go one level down, which is also known as a component. In the first component or operating segment, the fair value of this segment is, let's say, '$2,000. The carrying value that we have is $1,500. So $500 is the excess. According to step one, if we're positive in this step, we don't need to move on to step two. So unit one was fine.

Now we move down to reporting unit two. The fair value is $1,000, the book value is $1,200, and we have apparently an impairment here. The next step is to determine how much that impairment is, and it's not the $200; it could be some other number. What you need to do is take that fair value and split it up into components. 'In this example, net assets is one major component, and then I also have the fair value of the value of business acquired (VOBA) as well. That's really an intangible. After you've done any impairment testing on the VOBA, and you look at the fair value of your assets, the balance is going to be what we call the implied goodwill. In this example, the implied goodwill is $150. What we happen to be carrying on the books for this company is $400. So the goodwill impairment charge then is $250.

I want to address a couple of additional impairment issues. In my experience, a fair value of an acquisition is not readily available. That's 'assumed here, and that's how the impairment test works, but that's where being an actuary really becomes difficult, I guess. It requires an actuarial appraisal.

Even if you do have a market value of a company that you own, suppose you have minority shares out in the public, you might have to split up that value according to reporting units. So, that said, you need to allocate that anyway, and we're probably back to an actuarial appraisal again. Actuarial appraisals require a lot of work, they require good models, and they can be quite subjective. I've been in bidding situations where plus or minus 25 percent of the average appraisal is not unusual.

Also, one other thing you need to be very concerned about in the new methodology is these reporting units. As you split the goodwill, it could have big potential impact going forward. In the example we used, the one unit was fine, but the other one had impairment. Even though, in total, we don't seem like we're impaired, we're writing down the impairment, which, six months from now, 'is going to hit your operating income. That's something to treat very carefully as you go through the initial purchase accounting.

Overall, I welcome the changes to FAS 141 and 142 as being in the right direction. My only caveat is 'that if you're looking at the H-GAAP borrowees, and you're comparing it to P-GAAP, it's like apples and oranges. You have H-GAAP as historical. P-GAAP is more of 'a fair-value measure of sorts. At least it starts out to be a fair-value measure and then gravitates a bit toward historical value. To use a simple example, if you have a 'healthy growing public company earning, say, 15 percent ROE on an H-GAAP basis, that might only translate to 7-10 percent on a P-GAAP basis.

MR. BRIAN CAMPBELL: I have a question on how you would go about defining your reporting unit. Would it be a similar level as you would normally define for loss recognition, which would put it at a fairly high level, or is it finer than that?

MR. BOLTZ: It starts out to be the same operating segments, according to FAS 131, but then it can go a level below that. It depends on whether the businesses are materially different within those subsegments of the segment. If you can argue that you don't have many differences between the subsegments economically or businesswise, you could keep the same operating segments, according to 131.

MR. BEVACQUA: I'm going to focus my remarks on what I'm calling other GAAP issues, which is intended to reflect the carve-out of some of the discussion that Daryl just had on purchase accounting, which certainly is one of many events that have taken place over the past year in the area of GAAP accounting. The two areas that I'm going to focus on are, first of all, the draft standard of practice (SOP) under development relative to nontraditional long duration contracts as defined under FAS 97.
The other thing that I'm going to try to cover is some of the accounting issues that are currently being wrestled with within our draft SOP development relating to internal replacements. That is still in the very early stages and both are under development. So I want to issue a caveat about my remarks so that everybody understands that this is still somewhat of a moving target.

First of all, for the nontraditional long-duration products, 'there was an exposure draft released in late March. At least, I know I was able to get a copy of it from the Web site then. And there is a final SOP that's scheduled to be released some time in the third quarter of this year. The major areas of the SOP that I'm going to focus on are, first of all, determination of liabilities in excess of policyholder account balances. I'll discuss some of the direction that the accountants are taking those considerations and the situations in which it would and would not be appropriate to record such liabilities.

The second thing I'll covers is that the SOP 'gets into a lot of discussion around determination of significant mortality and morbidity risks, which is a pretty critical part of the GAAP framework to get to the appropriate product classification for a certain type of contract — that is, whether it's an investment contract or a universal life/insurance contract under FAS 97.

Once some of those determinations are made, the SOP goes into a fair amount of discussion around certain considerations related to contracts with death or other insurance benefit features, as well as the contracts that provide only death or insurance benefit features.

Finally, the SOP rounds itself out by talking about some of the accounting issues relative to sales inducements, clearly a feature that has become very prominent in the marketplace relative to some of the new products that have been going to market.

This SOP currently is on a fast track. They are hoping to have this effective by the end of the year and are actually encouraging early adoption of the draft SOP.

In terms of the liabilities, in addition to policyholder account balances, this is really something that came about from some of the new product trends that have been coming to market recently that were not contemplated when FAS 97 first came out however many years ago that was. They've revisited the definition of a policyholder account balance and have defined it in the context of historical deposits, net of withdrawals, plus amounts credited, less historical fees or charges.

Plus, there is this new thing called an "additional interest component," which we'll talk about in a little bit.

It also has some other adjustments that might be associated with appreciation or depreciation of certain assets that might be supporting those account balances. This additional interest is an amount that would correspond to some amount that hasn't yet been credited to the policyholder account balance, but would be payable in cash or some cash equivalent form to the policyholder at the earliest of an interest credit reset date or at contract maturity. This is a fairly broad statement, but I think it's one that is continually referenced as the SOP starts to go down its list on a contract-by-contract basis as to whether we do hold some additional provision above and beyond the historical account balance reporting.

The first consideration SOP gets into surrounds the contracts that have more than one account balance, and there are a number of them. Some of the ones that are more noticeable would be things like secured annuities and contracts that might have certain minimum guarantees associated with them. What the guidance in the draft SOP basically says is that you need to be looking at the highest contractually determinable balance available in cash or the cash equivalent amount at the earliest of maturity or the interest credited reset date.

The SOP then further expands on this to note that the liability should be determined in the absence of any kind of a policyholder action. So, to the extent there is a market value annuity that would apply an adjustment upon surrender of the contract, the SOP says you should not contemplate a surrender election by the policyholder and, therefore, a market value adjustment in reporting that liability. So that would not be an additional amount that would be included for that type of a contract. Similar to two-tier annuities, you would not contemplate an annuitization election by a policyholder in determining the liability. Hence, you would essentially accrue the lower tier of the policyholder account balances for purposes of reporting the liability under GAAP.

As for annuitizations, the SOP did get into a fair amount of specific discussion around a deferred annuity in the accumulation stage that might have certain guarantees associated with it. The discussion was whether that guarantee should possibly give rise to some type of an additional liability, in particular, if there's a very liberal provision, for example, in the guarantee of the purchase rates associated with those provisions.

The direction that the accountants took was to say that there is no mortality risk that exists within the accumulation part of the annuity phase of a contract, so, therefore, there should not be any type of liability associated with this particular provision during this phase of the development of the product. The Accounting Standards Executive Committee (ASEC) did notice, however, that there clearly is an economic pricing risk associated with this. But, I think, for the reasons stated before, they couldn't go far enough to determine whether it would be appropriate to report a liability or not.

One observation on this, which I think hasn't been addressed, but it's still an interesting question, is whether, when you go through loss recognition or probability testing of GAAP on a deferred annuity, you should or should not include annuitizations within that determination as well. It's unclear. I think you can probably argue it either way based on what this is saying, but it's an observation I'd like to put out there for your thoughts.

Next, the draft SOP gets into a fair amount of discussion around the determination of significant mortality and morbidity risks. This ends up being a pretty critical part of the overall draft SOP because there' are many ramifications in terms of your ability to record additional liabilities, depending upon exactly how this test breaks out and where a particular type of contract would fall in terms of classification as an investment contract or otherwise.

The nature of the test' relates to looking at what they call a "mortality risk test," where you would look at the present value of all life contingent payments that will be payable in excess of the account balance divided by the present value of all fees and spreads and sources of revenue that the insurance company would recognize off of the policyholder account balance. To the extent that that ratio ends up being high enough to be deemed to represent a more-than-nominal risk exposure of mortality to the insurance company, then that would trigger treatment as either a FAS 97 universal life (UL) contract or possibly a FAS 60 contract if the provisions of the contract were not fixed. If the result of that test ends up showing that there is actually nominal mortality risk, then the product would be classified as a FAS 97 investment contract.

I should mention that, upon inception or adoption of this SOP, any existing contracts would have this rule applied at the point in time at which the adoption occurred. For new contracts going forward, this test should be applied at the point in time in which the contract is issued. So, it's kind of important to recognize that when you look at the current state of many guaranteed minimum death benefit (GMDB) features on contracts currently being in the money. I think this provision would allow a lot of those contracts, potentially, to qualify as a UL contract because of the significant mortality risk versus if you were at time- zero and trying to make the determination going forward.

If you end up passing the test and become an UL contract, the SOP then goes on to say that, to the extent that you have situations where you have fees being charged for certain risks that are not proportionate to that risk, you need to accrue a liability. This goes back to the age-old GAAP adage of trying to match your revenues and your expenses. A couple of examples of that would be GMDBs where you might be funding for those amounts using a fixed-basis-point charge against the account balances and UL contracts that might have reverse select and ultimate cost of insurance rates. You would need to accrue a liability.

And, interestingly, the draft SOP is not looking at a static set of assumptions for determining this liability, but actually looking at a range of scenarios and weighting them by an appropriate probability in coming up with the determination. I took a step back and observed that this is probably the first time that the FASB seems to be going a step in the direction toward a fair-value/dynamic view of looking at the future and coming up with appropriate liabilities within that context. So it's a bit of a milestone in that sense versus the traditional estimated gross profit (EGP) approach, which is more static under GAAP.

FROM THE FLOOR: How does that differ from the unearned revenue that is currently in FAS 97?

MR. BEVACQUA: The distinction is that an unearned revenue liability would normally be something that would represent a specific charge, I guess, that would be assessed against the account value and then amortized as DAC would normally amortize. In this situation, sometimes it's not as clear that these amounts are necessarily unearned. For example, looking at a GMDB cost, a lot of times those are defined in terms of a fixed number of basis points over the lifetime of the contract.

Looking at that on the surface, it's not as clear that that normally would be an unearned revenue component, compared to looking at a front-end load on a contract. So it's drilling down to a bit more detail when you start to look at the underlying risk it's supposed to be funding, to the point that, all of a sudden, you start to understand the consistencies in terms of what that is versus what you might see with the front-load end.'

FROM THE FLOOR: I have a question on multiple accounts. Would that also include things like a notional account used solely for determining secondary guarantee?

MR. BEVACQUA: I'm sorry. Could you repeat the question? I'm trying to understand it correctly.

FROM THE FLOOR: A lot of the UL contracts now have an account that is calculated solely to determine if the contract would stay in force if it wouldn't normally because of cash value running out.

MR. BEVACQUA: Relative to secondary guarantees, I would tend to think that what would happen with is that I wouldn't see much of a change affecting how that would normally be reported as a result of this SOP. My suspicion would be that it would be business as usual as a result of it. Certainly, if anybody has any comments on that, you're welcome to open the floor because this is intended to be an interactive session, and healthy discussion is always encouraged.

Moving on to the next step, once we put out there that we need to calculate a liability for a certain life contract, to the extent that we' have this timing disconnect between the funding of the benefits and when those benefits would actually be paid, the draft SOP does start to lay out some of the mechanics on how you would actually go about calculating this liability. It's what I generally refer to as the benefit ratio technique.

The basic steps of coming up and accruing this liability is to first derive a benefit ratio, which is expressed as the ratio of the excess life contingent payments, plus any related expenses to be incurred related to paying those payments, divided by the present value of all fees and spreads that would come out of this policyholder account value.

There's no attempt here to try to match specific fees within the contracts to specific benefits. What it does is simplistically look at all the fees that would be generated from the contract and assume essentially that the reserve or liability would be funded from a pro rata slice of that stream of revenue expected to be generated from the contract. The liability would then be calculated by applying, historically, the benefit ratio to the historical fees and spreads that have been recognized actually within the contract, less the accumulated amount of actual excess payments and related expenses incurred. I should note that the liability can never go negative because, in general, that's a no-no under GAAP. You can never hold a negative liability.

The SOP says that this is something that's going to be dynamic. We need to go in and continually reassess the assumptions that we're making on the prospect of determination of the liability. And we need to recalculate a benefit reserve factor and then essentially redetermine what today the amount of this liability would actually be. So there are a lot of dynamics in play that would be very akin to the type of unlocking exercise that you would normally see with DAC, where there's going to be a requirement to go in, calculate a new benefit ratio that will be analogous to an amortization ratio under DAC and then have an accumulative catch-up and unlocking that would run through earnings in the current period.

Also, within the mortality risk test, there is a recognition that you would need to look at more than just one static scenario, but rather look at a range of scenarios and weight them with a specific probability in actually determining the present value of future revenues as well as the present value of future excess payments.

The next thing that the draft SOP attempted to tackle were situations in which a reinsurance company or even an insurance company enters into a contract with another insurance or reinsurance treaty or, perhaps, with some other mutual fund company. It sought to provide more guidance about how companies should be applying the certificate of mortality determination for such situations.

Essentially what the draft SOP says is that you really need to be looking through whatever the underlying product that the direct rider might be selling and look specifically at the risk position of the reinsurer or insurance company. So, to the extent, for example, that an insurance company might be selling a GMDB wrap around a mutual fund, essentially the insurance company would just look at its own insurance risk in going through and applying its own mortality significant risk determination to figure out how to qualify that treaty within GAAP.

Also, as we mentioned with the UL contracts, to the extent that there is a disconnect between how these treaties are financed and the incidence in which these benefits are going to occur, there would be a need to report an additional liability to match the revenues and expenses for these situations.

As for sales inducements, there's a pretty wide range of different types that are out there in the marketplace. I think the working group attempted to recognize that when they crafted some of their provisions. The provisions do apply equally to investment contracts and insurance contracts. There's no distinction in terms of sales inducements as to how this should be applied to those types of contracts. What they attempted to do was to emulate an effective yield model so that there was essentially going to be an effective return to the contract holder over the lifetime of the contract, comparable to how the accounting works for a lot of debt securities. Often, when the accountants look at account balances on UL-type contracts or annuities, they always tend to gravitate to debt instruments as being a good parallel for them to assess how to deal with these things from an accounting perspective. I don't know why that is, but it always seems to be the case.

The characterization of how to deal with inducements, in general, is to say that you need to recognize that as part of the liability during the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date earlier. There's also no reduction for any anticipated surrenders or even any adjustment for any anticipated levels of persistency. In looking at a traditional bonus product, where there would be an immediate bonus enhancement to the account value at time- zero, you would include that bonus credit as a part of the policy account balance that would be disclosed on the balance sheet.

Offsetting that is a contra-liability. The draft SOP says that what you need to do is capitalize these bonuses and amortize them using the exact same mechanics as DAC. It's not going to be included with DAC. It will be a separate balance sheet item, but the basic mechanics in terms of EGPs and so forth would be exactly the same as what you would do with DAC.

To qualify for this accounting treatment of these inducements, there' are a couple of criteria that you must be able to meet. First of all, the bonus provision has to exist within the contract. To the extent that an insurance company might actually have a program where there's more of an ad hoc matter—for example, people with bonuses to their account values that is not included within the contract—the SOP says that you would not qualify for the accounting treatment described here in terms of the sales inducements.

In addition, the insurance company is going to have to be able to provide certain demonstrations. For example, the incremental amount associated with the inducement has to be incremental to the amount credited to similar policies without the inducement, and that would have to be demonstrated. Secondly, to the extent that there's a higher-than-expected credit rate after the inducement, it would also be a sufficient representation that this, in fact, is an inducement associated with the sale of the contract.

In terms of the transitioning, this is something that's going to be applied prospectively, so there's no need to get any kind of restatements or historical adjustments to reported earnings. However, to the extent that there's a practice where a company has been deferring some of these bonuses in some other way — perhaps in proportion to over the surrender charge period or other things that people might have been doing in the absence of guidance — the draft SOP says to take that outstanding balance, view it from the old amortization basis into the new amortization basis, which generally would be EGPs, and then go forward on the new amortization basis with no real profit and loss (P&L) effect as a result of any kind of an adjustment for a different amount that would otherwise arise at the time of adoption.

Let's go through some of what this means in terms of specific features that exist now in some of these contracts in the market. For GMDBs, you first need to determine whether you're going to pass the mortality risk test or not. If you do, then you would normally accrue an additional liability for those amounts using the benefit ratio technique. To the extent you don't pass the mortality risk test, essentially it's a pay-as-you-go arrangement, and there's no additional liability to be reported as a result of the GMDB.

Guaranteed minimum accumulation benefits (GMABs) present a situation in which a minimum account value will be available in cash at a specified date. This is something that is typically going to be identified as an embedded derivative within FAS 133 and, therefore, would be bifurcated from the host contract and valued according to the terms of 133. So, from a GMAB perspective, this SOP, to some extent, is going to be somewhat of a nonevent. It's going to be dictated more by the 133 provisions.

For guaranteed minimum income benefits, 'there's not going to be any additional liability held during the accumulation phase unless, for some reason, that benefit could be net-settled at the point in time at which it would become effective. If that's the case, then perhaps it's the FAS 133 situation. But here, again, it's another example of where there's a bit of a disconnect between looking at the annuitization phase versus the accumulation phase.

Finally, for income protection benefits, this is going to follow the same type of mechanics that a GMDB would, in that you need to go through the same type of mortality assessments, and the same treatment would result from the outcome.

Now we're going to shift gears to internal replacements. 'This is in development. The guidance is very limited. The only reference right now about to how to deal with this is in FAS 97, where they talk about replacing a UL traditional life contract with a UL contract. In that case, you would write off the DAC and basically move forward from that point. However, it's very specific, and there's a need to create more standardization in the industry because there's been a variety of practice.

The direction the working group is going is to pull together a test to determine whether the new contract is substantively different from the old contract. To the extent that it could be demonstrated under the criteria laid out in the draft SOP that it is substantively different, then you would treat it as though it's a lapse and a new contract. To the extent it's not substantively different, but more of a continuation of the old form of coverage, then the intent under the SOP is to create a P&L-neutral event, which would mean that you would not write off the DAC. You would generally forward them to the new EGP stream and try to make it as seamless as possible from an earnings perspective.

This does not, by the way, include any type of enhancements that might be associated with the unilateral effort by the company to enhance the benefits to be given across a class of policyholders. This is a bilateral transaction that must exist in order to qualify the treatment of an internal replacement.

Initially, the working group was going with a two-part test: a qualitative component as well as a quantitative component. They seem to have gone away from the quantitative aspect because, I think, what they found is that, in general, you're never going to see differences in EGPs of more than 10 percent. So, it ended up almost like a nonfactor and washed out. They are now focusing more on a qualitative test, which is still currently under debate across many of the considerations.

'The working group has identified about eight different things as characteristics of a new versus old contract that would likely consider deeming a new contract to be substantively different from an old contract. I won't go through the list in the interest of time, but at least note that a number of those things are still being debated because they are not as black and white as you like them to be in many instances.

Next, I'll talk briefly about some of the challenges associated with carrying forward DAC to the extent you've got a contract that is not substantively different. The draft SOP does suggest two possible methods. Method 1 would be a process in which you would actually try to take the EGPs on a new product, bring them in to where the old EGPs were in the DAC amortization schedules to where the old product was and then continue forward as usual, like you're slipping in the new EGPs for the old ones. Obviously, it would be an administrative nightmare to try to match up exactly where the old one was and where the new one is and to get things to work through.

So a second method 'has been proposed that involves taking the DAC on the old block of business and then trying to determine what proportion of that DAC was associated with policies that have been replaced. And one technique that's been proposed is to do it in proportion to expected gross margins (EGMs), where you look at the present value of the replaced sources of nonreplaced and then, on a pro rata basis, split the DAC and move that DAC under replaced products over to the new schedule for where that business would exist, which obviously would be a bit more work on the front end, but less of a nightmare going forward.

As for reserves, the earnings effect isn't limited to DAC, but it is possible there could be some seams resulting from differences in account balances. To the extent there is a seam as a result of sales inducements, I'll refer you back to our prior discussion about how those are accounted for. But also note that there are some anomalies that have come up within the working group relative to how the accrual of the liabilities were done and an inducement does come about. 'Keep your eye out for that.

Finally, on FAS 60 products, there has been no specific discussion presented yet as to what would happen assuming you have a seam on FAS 60 products, although I would tend to point to one possible solution being the defined initial reserve method, which is used in purchase accounting. It allows actuaries to come up with a reasonable reserving basis that would dovetail initially from an initial reserve balance and then, from that point forward, rely on the assumptions that the actuary might make that would underlie the FAS 60 reserving mechanisms.

FROM THE FLOOR: At my company, Guardian Life, we have a little FAS 97 business, but lots of traditional business. My understanding is that the replacement part of your discussion applies to my traditional business as well as my nontraditional business.

MR. BEVACQUA: That's right. The replacement part is very broad. It's not specific to 97 products.

FROM THE FLOOR: So, am I to understand from what you said that, in a business like ours, if you have a term product and then we encourage our policyholders to convert that to whole life, that would fall under this discussion? In other words, you have to somehow do something to maintain the old DAC even though there's a new commission on the new products? And, if so, how would you convert from FAS 60 to FAS 120? Up to this point, you have no specific margins at all. Now you suddenly have to consider EGMs. How do you complete the DAC or the benefit reserve on such a totally radically different basis?

MR. BEVACQUA: I think that's what they were trying to get at with a rather lengthy list of criteria that you could meet to be deemed substantively different. And', to the extent the new contract is a FAS 120 contract and the old contract was a FAS 60 contract, 'one of the items on the list there is that you'll have substantively different contracts. Therefore, you treat it just like the old one lapsed and the new one is a new policy. So I think there will be more or less an extension of the way things are carried forward today.

I don't think the work group was completely unsympathetic about what could possibly come about from this. And, in fact, the overall direction, I think, of this is almost to create a burden of proof in order to be able to qualify as being not substantively different and to carry forward the DAC. That's my interpretation of how I see some of the things in the draft SOP, relative to how it might otherwise come about.

Chart 1

NAIC ERRAF - Goals

- Formalize structure for evaluating risk
- More effective use of the risk-based examination approach
- Increased consistency across states
- Additional training of examiners and increased cooperation with internal auditors

Chart 2

NAIC ERRAF – Risk Classes

- Credit
- Market
- Pricing/Underwriting
- Reserving
- Liquidity
- Operational
- Legal
- Strategic
- Reputational

Chart 3

NAIC ERRAF - Tools

- Potential new tools/processes:
  - Insurer profile form
  - Enterprise risk assessment form
  - Revised examination checklist
  - Enhanced coordination with auditors
  - Risk management best practices
  - Enhanced resources for examiners
  - Risk scoring system

Chart 4

Identifiable Intangible Asset Summary

	Indefinite Useful Life	Finite Useful Life
Characteristics	No legal, regulatory, contractual, economic or other limiting factors	Expected useful life is limited
Amortization	None	Over useful life
Impairment Test Timing	Annually or sooner if required by circumstances	Whenever it might be impaired
Impairment Test Methodology	One-step (fair value) test	Two-step (SFAS 121) test

Chart 5

Goodwill Impairment Test

- Step 1 : Is fair value greater than carrying value? If yes, done.
- Step 2: Allocate fair value to all assets and liabilities as if just acquired.
- Compare resulting goodwill.
- The allocation process is for impairment purposes only.