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## Session 49OF
## Annuity Financial Reporting Issues


**Track:** Financial Reporting

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**Panelists:** ROBERT G. FRASCA
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TIMOTHY J. RUARK



*Summary: Attendees learn of recent financial reporting activity, including Actuarial Guideline MMMM, the new AICPA Standard Of Practice (SOP) on Non-Traditional contracts, a new SOP on internal replacements, and treatment of annuities under proposed international accounting standards.*


**MR. MICHAEL J. O'CONNOR:** There are three of us speaking today. Tim Ruark is the president of Ruark Insurance Advisors, which provides reinsurance consulting services. He was with CIGNA for 15 years. I'll be the second presenter. I've been with Tillinghast for about a year, and for 21 years before that I was with a couple of different insurance companies in a variety of capacities. Rob Frasca is from the Ernst & Young Boston office. He specializes in financial reporting issues, and he was formerly at Sun Life and New England Life.

**MR. TIMOTHY J. RUARK:** We started Ruark Insurance Advisors about four years ago. You can pack a lot into four years. For four years, many men and women have toiled in the industry to develop a valuation guideline for what we call VAGLBs, variable annuities with guaranteed living benefits. Eventually, that work became known as Actuarial Guideline MMMM, the actual recommendation on how you do the valuation for VAGLBs. On April 25 of this year, the Life and Health Actuarial Task Force (LHATF), which is connected with the NAIC, decided that maybe MMMM is not such a good idea after all. So when you think about all you could do in four years, you can think about those people who volunteered—the Steve Prestons, the Tom Campbells, and others—just like that gone in a heartbeat.

The first phase I was going to talk about was the Commissioner's Annuity Reserve Valuation Method (CARVM) and Guideline 34, VAGLBs, reinsurance consideration and recent activity. That was my presentation, until they eliminated MMMM.

I'd like to talk about whether MMMM is dead. Is it absolutely dead? No, probably not. Certainly in my line of work, where our company does an awful lot of consulting and analysis with respect to before and after reinsurance, some of the concepts in MMMM are really, really useful, and so my company is still going to be active in doing things connected with the MMMM approach for the foreseeable future. But will MMMM become a law? Will it become the regulation for guaranteed minimum income benefits (GMIBs) and guaranteed minimum accumulation benefits (GMABs)? I think not at this point.

Let me just cover a few things to get everybody up to speed. I'm sure some of you are well aware that this had occurred, but for others this is brand new. LHATF redirected the project. Why did they do that? The official line, which I think is the right line, is that it became obvious that the reserving mechanism was not going to integrate very well with risk-based capital (RBC), and those two were not going to talk to each other very well. This has always been an issue with CARVM and variable annuities, but in the case of Guideline 34 for guaranteed minimum death benefits (GMDB), it was just felt that in the big scheme things under CARVM, death benefits tend not to have a huge consequence. So you're able to look by the fact that there was some mismatching going on.

With the living benefits, you couldn't do that anymore. I guess it just came to a head. Even in the last presentation, on the 25th, by the Academy group to LHATF, there were still debates about different facets of Guideline 34. It was still very open to discussion. I wasn't there, but I get the image of folks in LHATF just saying, "The heck with it, start over." I hope they get volunteers for the next four years because as any of you who have been on these types of committees knows, it's a thankless job. If the only thanks you get is somebody like me mentioning your name four years later, it's a thankless job. So I hope that they get some volunteers.

What's next? The first thing that happened was that there were three separate groups that have come together to become a joint group. There was the VAGLB task force, the ones that came up with MMMM. There was the C-3 Phase 2 Task Force. They were dealing with C-3 issues with respect to variable annuities. They're focusing, I think, on GMDB right now. And then there was the standard valuation law group that was thinking about the longer-term, where we should go, should we replace CARVM, is there a better approach to valuation and those types of considerations? The three groups are now together, and it's a joint group. The joint group has made a recommendation that's going to be delivered, I think, next week at the NAIC meeting in Philadelphia. The recommendation is really a three-part recommendation. The first two will be discussed in Philadelphia. They want to defer the third recommendation until the next NAIC meeting in September. The third item that they want to address is this idea of, longer-term, what should be the direction of reserving, RBC, etc. on variable annuities.

In the meeting next week, they really want to focus on what we're calling the interim solution. If MMMM is gone, what do you replace it with? This is becoming more and more pressing because more and more companies have been developing living benefits and offering them for sale. The joint committee has recommended six different techniques or approaches to the interim calculation of VAGLBs. But at the same time they're presenting those six, they're basically saying that four of them aren't going to work. So they're really suggesting further review of two. And the two that they're going to recommend both deal with the retrospective accumulation of the fees. Whatever you're charging, and most people are charging extra for the VAGLBs that become their reserve and it accumulates.

I'm not going to kid you. This is a lame approach to reserving these benefits. I'm in this stuff day in and day out, so I understand all aspects of the risks on VAGLBs, but I don't think there's anybody on the committee that thinks this is a very good long-term approach. But we are seeking something in the interim to put in place. One recommendation is just the retrospective accumulation of fees. Maybe there's a mechanism to release those fees in time, maybe not. Maybe they're only released when people lapse, I don't know. So that's part of one recommendation.

The other recommendation is the same as the first one, except they're going to layer on top of it what's being called an asset adequacy component where you would go in every now and then and evaluate whether the retrospective component is working. As far as I can tell, there's no discussion of what happens when the answer is "No, it's not working." What do you do? I think that's to come. They're waiting for next week to get a little bit of feedback from LHATF. They'll ask LHATF, "Where do you think we should go?" And then, depending on what LHATF says, that will help them put a little bit more meat around the bones of these two ideas.

Why is this simple retrospective accumulation of fees so lame? It is simple—that's the pro. And they list a few other pros, but I think they all come back to the fact that it's simple. So that's really the only pro that you have on it.

The cons are numerous, but there are two key ones. The first one may be obvious. It would mean that the less I charge for the benefit, the lower my reserve. That's right. That's how that would work, so that's not very good. The second one, which I think is even more important, is that you have a totally different risk profile when the contracts get in the money compared to when they're not in the money. This has been a constant battle for four and a half years as regulators have tried to create reserves at time zero. Well, that's hard to do on the way most of these things are designed. They really are not that risky at time zero, at least in a statutory reserve framework. But that can change quickly, and it has changed quickly for people that wrote GMIBs before 2000. Lots of those contracts are in the money. We get very different answers for those contracts today than you get for a brand new contract. Fortunately, for this interim solution, if it's truly a short interim, like within six months before something is replaced, that's probably not going to be a big deal. But judging by how long it took to get to where we are and how quickly that got thrown into the hopper, I don't know how long it's going to be. These contracts that are in the money right now—and, remember, a lot of them would have been the initial designs of GMIB, which tended to have seven-year waiting periods, a little shorter than what's typically out there today—are not far away from being exercisable, so we'll see what happens.

**MR. O'CONNOR:** I was hoping that we would actually have some late-breaking news with respect to this draft SOP that has been promised for months, if not a year, but we don't. It has not been issued yet for exposure. As you probably know, there is somewhere in the halls of FASB a draft SOP on the non-traditional long-duration contracts covering several items that we're going to talk about today.

An AICPA task force has worked on the subject of non-traditional, long-duration contracts for three to four years. And finally, last September, they cleared a major hurdle within the accounting profession, when the Accounting Standards Executive Committee (ACSEC) group approved it. The draft had a "positive clearance" in March of this year. I think that means that it was formally presented to FASB. The expectation back in September was that there would be an exposure draft publicly issued sometime this quarter. Since it is getting late in the quarter, who knows what's happening?

So what products are going to be impacted by this? The main impact is going to be on variable annuity GMDB valuation, separate account presentation and valuation, and sales inducements.

Let's talk about the specific issues that are expected to be in this draft SOP (Table 1). Typically, separate account assets and liabilities show up as a combined entry on the asset side and the liability side; that's going to get tightened up in terms of what types of assets and liabilities will qualify for that treatment. Definitely, there will be changes on the liability valuation. The two main areas impacted are, again, the fourth from the bottom—significance of mortality and morbidity risks on variable annuities—and sales inducements.

Table 1

## Draft SOP on Nontraditional Long-Duration Contracts

- Issues Covered Include:
  - Separate Account Presentation
  - Liability Valuation
  - Return Based on Pool of Assets or Index
  - Annuitization Features
  - Significance of Mortality and Morbidity Risks
  - Contracts with Death or Other Insurance Benefits
  - Sales Inducements
  - Transition

The industry has had separate account GICs for decades. These are GIC contracts in a separate account. The way a lot of companies have been presenting these liabilities is as a sum total with the variable annuity separate account assets and separate account liabilities. The totals are entries included in the company's total separate account assets and liabilities. Sometimes, companies have also included their seed money in the separate accounts as an asset.

The new practice is that you can keep doing that accounting treatment only if it's a legal separate account. The assets are segregated from the general account; the policyholder directs the allocation of investments and all the investment results pass through to them. For instance, a couple of companies have an equity index annuity in a separate account. The policyholder doesn't direct the allocation of any investments, and all the investment results don't pass through because the index gets credited completely independently of what happens on the investment side.

On the subject of seed money in the separate account, it will be classified as a general account asset. It will show up on your asset side and your liability side just as if it were general account money. Any changes here would be just a change in accounting.

On the liability valuation side, there are a couple of types of contracts that are impacted by the second and fourth bullets. They are commonly called two-tier annuities, and this is a niche product in the industry. The contracts have a lower account value for surrenders, and if they annuitize, they get the upper account value. For GAAP purposes, many companies have been funding a reserve that is in between these two account values. The calculation is done via typical actuarial projections. You have your current in force, the attained age of people, and you calculate the present value of future annuitization benefits, assuming some pattern of annuitization in the future. Discount that back to the valuation date, and that is your additional GAAP reserve.

But the SOP is expected to say that you can only have a GAAP reserve equal to, in this particular case, the lower tier because that value is the only one that is available in cash. Annuitizing is viewed as establishing a new contract. For purposes of valuing the current contract, it's a notional amount, but in terms of GAAP benefit reserving, you will no longer be able to reserve for the expected annuitization costs. You also will not have any reduction for market value adjustments and, as is the case now, there's no reduction for surrender charges.

A lot of this was driven by the fact that there was a fair amount of diversity of practice, especially for market value adjustments. Part of the goal of the AICPA task force was to get more uniform accounting practice on some of these issues.

For a policy that has a return based on a pool of assets either through the crediting rate or through some market value adjustment upon termination, the liability now will be based on the fair value of the underlying pool. For example, there have been several products over the past three to four years generically called pass-through products. They are deferred annuities, but the customer gets some type of pass-through from some underlying pool of assets. Your response probably is, "Well, so what? What's the big deal?" The issue is what's happening on your asset side. If your assets are classified as held-to-maturity, you're recording those assets at book. Yet, you have a liability that's at market. What companies will probably tend to do is put those pools of assets into their trading account and, hopefully, they will have a good match between the assets and the liabilities.

For two-tier annuities, there's no extra liability above the lower account value. At transition, let's say that your company has a big additional reserve beyond just the lower value. You would have to release the reserve. It would not go through operating income; it would go through as a change in accounting. And in the future, as people do annuitize and you have to step up the reserve from that lower account value to something higher, that would just flow through as a negative variance or a loss in your income statement.

To pull it all together, in this draft SOP, they're making a strong point that elective benefits cannot be reserved if the product is an investment contract under FAS 97. And that's a big if, and we'll get back to that on the variable annuity side.

So how about variable annuities with mortality and morbidity risks? I'm not aware of any variable annuity with a morbidity risk, but if you go back to FAS 60, they tend to lump mortality and morbidity risks together in terms of classification of contracts. There has been a range of practice in the industry in terms of what to do with the GMDBs. Some companies have been accumulating fees minus costs. Some have been holding statutory reserves. Some use the statutory reserving framework, but with less conservative assumptions. And other companies have been doing some type of option pricing. On the living benefits, there has also been a range of practice, including establishing no reserve.

Under the new requirements, the first step is that you have to determine the classification of your variable annuity. If you go back to FAS 97, Paragraph 15, "Investment contracts do not incorporate significant insurance risks." That phrase goes back to mortality or morbidity risks as that concept is contemplated in Statement 60, "It shall not be accounted for as insurance contracts." And in Paragraph 40A, "Nominal mortality risk, if it's insignificant or remote is not sufficient to permit that a contract be accounted for as an insurance contract." For those of you who weren't around back when FAS 97 was being finalized, companies and actuaries were making the point that, "Well, I've got this annuitization feature in my deferred contract, and I have this guaranteed life contingent payout annuitization rate. That's a mortality risk."

Since then, the accounting world has gotten closer to saying that's just a totally separate contract, if and when anybody annuitizes. While it might be accurate that you have those guaranteed life contingent annuitization features in the contract, from an accounting classification perspective, that's irrelevant. You have to determine the significance of the mortality risk, and you compare the present value of the excess benefit payments, the minimum net amount at risk, to the amount assessed; in effect, your revenues under the contract. And that's all of them. It's not just your GMDB fees. According to the AICPA draft SOP, a key phrase is "reasonably possible outcomes." While this apparently will not require a stochastic valuation to make this determination, it clearly includes using that approach. It also precludes a deterministic approach. Under a deterministic growth rate of, for example, 9 percent, most death benefits wouldn't be worth anything.

So what happens if you have a mortality risk that's other than nominal? If it is, it's not an investment contract under FAS 97, but a universal life-type contract. Going back to FAS 97, Paragraph 20, "Amounts assessed that represent compensation to the insurance for services to be provided in future periods are not earned in the period assessed." In effect, you have to set up a liability for future costs. I've always wondered about that word "services." Insurance "costs" or something like that would have been better, but that's the way it reads. At transition, assuming this draft is effective, let's say, 1-1-04, or sometime next year, perhaps, you would have to determine the significance for your in force separately from your new business. You could be in a situation that your in-force business has a material or a significant mortality exposure, but your new business doesn't. Your new business classification could change over time as your product designs change. So the reserve will be very similar to your deferred acquisition cost (DAC) calculation.

You have to determine a level charge for the death benefits over the life of the contract. You retrospectively accumulate your X basis points for death benefit costs and you have a prospective component, a discounted value of projected costs. So you have to reevaluate what X cost is. How many basis points do I need? As your benefits go more and more in the money, you have to reevaluate what your current estimate is over the lifetime of the product. Like in the DAC, you're going to have some unlocking issues periodically. This is just one more dimension to unlocking, in effect. And you would need to coordinate this with the estimated gross profit (EGP) stream for your DAC.

On the sales inducement issue, the question has been over the last four years at least, "What's the proper GAAP accounting treatment of that bonus?" Let's say your base rate in today's environment is five percent. You tell a customer, "In the first year, we'll credit you an extra two percentage points and credit seven percent." What do you do with that two percent? I remember when I was at a company, going back and forth with the auditors about whether we could defer it. I believe that the AICPA task force flip-flopped a couple of times themselves in terms of whether you could defer it or not. The SOP will say that you can defer it if those amounts really are incremental and the total is higher than the expected ongoing crediting rate. With most of the ways that I've seen these types of products either communicated or illustrated, it's pretty clear that your base rate is, say, five, but in the first year you'll get seven. That will be pretty easy to verify at least. Your liability will reflect what you credited, but you can then defer that incremental amount as an asset, just like a DAC. The amortization of it, though, would flow through your benefit expense, not your DAC cost line. It would amortize very similar to the DAC asset.

Hopefully, there will be a draft SOP coming out in the next quarter or so, but it will be interesting to see what FASB does with it. It's kind of odd that a lot of actuaries are saying, "Well, wait a minute. No, we need to have these liabilities. They're appropriate liabilities." And in this post-Enron era, I'm hoping that somebody at FASB will take a step back and ask, "Why are we requiring that these liabilities be taken off the balance sheet?" And so, hopefully, there's some thought process about that going on in the FASB, instead of concluding that FAS 97 investment contracts would not permit these types of liabilities. Maybe they should step back and say, "Let's fix FAS 97." I'm hoping that those types of deliberations are going on in the FASB. But like MMMM, the AICPA task force has been working on this for three or four years. They're probably sick of it. They're probably thinking, "Thankfully, it's finally off their plate, done, and they can go on to other things." So there might be a lot of difficulty if FASB were to turn around and say, "We really thought you guys should have done something different. Why don't you go back and work on this for a couple more years?" As Rob pointed out, with fair value coming down the road, it probably wouldn't be worked on anyway.

**MR. ROBERT G. FRASCA:** I'm going to talk about two very different things. First of all, I'm going to talk about DAC on internal replacements. It's an issue that's a

U.S. GAAP issue. We're likely to see some guidance coming down the road on that in 2003. The second thing I'm going to talk about is how annuities are going to be treated under the proposed upcoming international accounting standards.

DAC on internal replacements is the issue of what do you do with DAC on an existing book of business, an existing block of annuities, say, where you have a replacement program. You want to give your existing policyholders an upgraded policy as a means of improving consistency. This issue has been around for a while and there's really no good guidance on it. Companies have been doing a bunch of different things. There's really a diversity of practice, and there's a real recognition now that there needs to be some kind of guidance. If you look at what guidance there is, currently, the only thing is that FAS 97 specifically says that you can't carry over DAC from a traditional life insurance policy like a FAS 60-type policy to a FAS 97 policy. But when you look at the guidance for the treatment of conversion from one FAS 97 product to another FAS 97 product, there really isn't anything out there.

There are four basic questions you have to ask. First of all, should DAC be carried over in a replacement transaction? Second of all, are all internal replacements covered or just some? And if not all are covered, then what are the criteria? Third, how much of the old DAC should be transferred and how do you do that transfer? And then, finally, are the rules different from those for modifications of existing policies? For example, suppose you have a conversion program where you really are requiring the policyholders to accept the brand-new policy. That would be a real internal replacement, let's say, in the true definition of the word. But what about situations where you just do a policy enhancement, where you unilaterally change some of the features of the policy? Does that fall into this or not?

The way things are right now, there's an AICPA task force that has been assembled. I don't know how long it's been around, probably a couple of years. Some preliminary thoughts have emerged and they do continue to evolve. There's nothing in writing yet. The only thing that has come out from the task force in terms of what they're thinking is that they are following along the lines of the emerging issues task force (EITF) 96-19. Basically, it's an accounting paper that talks about how you deal with changes in debt instruments. So that's kind of the model that they're going by. Finally, and probably the most important thing to get out of this session, and I think it's been amply said already, is that all of this is subject to change.

As of the beginning the year, the task force was using a decision tree format. What that meant is that you have this tree of decisions you go through. The first decision was what they colloquially called Dead On Arrival. So if you failed any of these questions in this first tree, it was over with. Your DAC would not be allowed to be carried over. The second was a qualitative test. This was a series of questions where if you answered all the questions right, then you were fine and that was the end of the game and you could carry the DAC over. Finally, if you didn't make it through the qualitative test, you'd go to a quantitative test. If you passed the quantitative test, then you're okay again and you could carry the DAC.

The Dead On Arrival screen dealt with very broad contract-type issues. For example, if you were looking at converting a group of FAS 60 traditional life insurance policies to FAS 97, it's dead on arrival. You have to write off the DAC. You can't carry it over. Similarly, if you're moving between, say, annuities and mutual funds, they're substantially different contracts, so you have to write the DAC off. Finally, if you go between life and health contracts, morbidity risk versus life risk, you're dead on arrival.

The qualitative tests included a number of tests that all tried to get at the question of whether the replacement contract is substantially the same as the contract that it's replacing. So you went through all these questions to determine whether it's true or not. You would look at the product features, the fees that are being charged, the benefits that are being provided, the sales process, whether any compensation was paid as part of the conversion, and whether the policy was re-underwritten. Were the account balances left unchanged? Again, this was another screen they used. If you answered the right way to all of these questions, then the two products are materially the same, so the DAC can be carried over.

The general sense was that it would be very rare for you to be able to answer right to all these questions, so you'd end up going to the third screen, which was the quantitative screen. The quantitative screen gets at an economic measure of the value of the business before conversion and after conversion, and what you do is a present value test. For FAS 97 products, so for most of your annuity products, you take the present value of the gross profit streams of the old product compared to the present value of the gross profit streams projected under the new product. You would do the comparison right at the first date at which the policyholder would be able to elect to convert the policy, and you would assume that everybody would do the conversion and then you would compare those present values. If they were within 10 percent of one another, you would have passed the quantitative test. You're substantially the same, so you're able to carry over the DAC.

This was the task force direction prior to April 2002. In April 2002, probably the day after they did away with MMMM, the task force decided that this approach might have had some flaws in it. In particular, it was the quantitative test that was the problem. They viewed the quantitative test as being too easy to pass. They couldn't think of a situation in which you wouldn't pass the quantitative test, so they went in a new direction, which is very much based on the qualitative approach. So it's kind of a combination of those first two screens, those first two sets of questions.

What they're proposing now is that you go through these series of qualitative factors to determine whether or not the new product is substantially different from the old. There is a little bit of a shade of difference of meaning here. Remember the qualitative test before was whether they are substantially the same, and now it's whether they are substantially different. So this is a little bit broader, I guess. You can probably say the two products are not substantially different more easily than you can say that they're substantially the same. In any event, the tests are very similar to the ones that I outlined before. They still have those Dead On Arrival-type tests where you have contract types, FAS 60 versus FAS 97. But even within contract categories, you have some nuances. So, for example, within FAS 97, if you're doing a conversion from a universal life-type product that has a material mortality risk to an investment-type contract, those would be considered to be substantially different because the nature of the contract was substantially different, so you wouldn't be able to carry over the DAC.

Even within an investment contract, if you were converting from a fixed annuity to a variable annuity, both investment contracts potentially, you still wouldn't be able to carry over the DAC. The thought there is that the relationship between the insurer and the policyholder, the relationship of the guarantee, is just different. The way in which you're guaranteeing interest, who is accepting the investment return, is different, so you wouldn't be able to carry over DAC.

So you've gone through this whole set of questions, and you decided you're okay. You can carry your DAC because this is deemed to be an internal replacement process in which you can carry over DAC. Well, the task force is currently exploring two different means by which you would then carry over the DAC. It looks like the first of these treatments, the one I'm calling Treatment A, is the one that the task force is going to recommend. I'm calling it the contract continuation method, which basically means you keep the gross profit stream intact that you had for the old product, but now your future expected gross profits are going to be based on your new product. You keep your historicals where they are. You keep your DAC where it was to begin with, but you could have potentially quite a bit of material unlocking because now you're projecting forward your future gross profit streams using the new product.

Treatment B is what I call the DAC roll-over method. You just carve out a piece of the DAC associated with the policies that are being replaced, and you move that DAC over to the new policies. You would set up a brand new gross profit stream for those new policies and that transferred DAC would be viewed as a new acquisition cost for those new policies to be deferred and amortized.

I have a few other miscellaneous issues. One is the issue of internal replacement versus policy enhancement versus the existing policy provision. Internal replacement is where you're changing one policy to another and the legal form is actually changing. Policy enhancement would be a unilateral change on the part of the insurance company to change some of the features in the policy. Treatment there would be identical. They would be indistinguishable for the purpose of determining whether or not you get this DAC treatment.

On existing policy provisions, let's say you have a policy that allows policyholders to make an election at some point in the future. Maybe they can elect to add a guaranteed minimum death benefit at some point in the future. The thought right now is that if a policyholder makes that election, it changes the nature of the contract. It changes it from an investment contract, say, to an insurance contract because now you have a material mortality element to it. It would be deemed to be a different contract, so you wouldn't be able to carry over the DAC in that situation. That's a controversial item, and it's one that's still up in the air right now.

Deferred new costs associated with an internal replacement is another issue. The thought right now is that if you pay commission but it's deemed to be an internal replacement, and DAC can be carried, then you would be able to defer that extra commission along the same way that you would defer renewal commissions on any existing policy.

The final issue is the accounting for sales inducements. The task force is trying to anticipate the implementation of the draft SOP that Mike was talking about earlier, the sales inducements, and there are a couple of approaches that could be used here. Let's say that you have a block of existing policies, and you're going to offer a one percent bonus to those policyholders who will change over from the old policy form to the new policy form. What do you do with the bonus? There are two ways of looking at it. One is that you would just start to defer the bonus from the date at which the conversion happens. The other is that you would look back and consider the bonus to be like a persistency bonus and start to accrue for it and defer the accruals from the original issue date of the contract.

In terms of timeline, you're probably looking at a final SOP in the middle of 2003, if we're lucky. But given some of the experience we've had with the other draft SOP, I wouldn't bet on any time frame. One thing though is, as I said before, a lot of companies have conversion programs and there's diversity in what they're doing. There are companies that don't have any sort of accounting policy right now on treating DAC on internal replacements. So at least this gives you something to look at as a potential way of doing things.

The next topic is international accounting standards. I'm just going to talk about the treatment of annuities under the proposed guidance for international accounting standards. Why should you care about international accounting standards? By 2005, all companies that are trading in stock markets in the European Union (EU) must report under international financial reporting standards. If you're working for a company that's required to report under these international standards, it's pretty important, I think, to get up to speed pretty quickly. The likelihood is that companies that are operating in the EU will have to comply shortly thereafter. There are indications that once international standards are set, Canada will probably follow pretty closely and then the United States will not be too far behind.

One big problem is that international standards for insurance contracts haven't been developed yet. There are two things that are out there. There is what is known as IAS 39, which is an international accounting standard that applies to financial instruments. It covers banks in particular. There's also a draft statement of principles which is being developed, which does cover insurance contracts and will likely form the basis for international standards once it's adopted.

I want to cover the landscape of products and of guidance. IAS 39 covers asset valuation. Basically, asset valuation would follow a U.S. GAAP approach, so FAS 115 and FAS 133 types of concepts are currently in IAS 39 for assets. Investment contracts are also covered by IAS 39, and these would include fixed deferred annuities where there's not a material mortality element. Unfortunately, IAS 39 specifically carves out unit-linked products, so variable products are not addressed by IAS 39.

The DSOP is being written to cover insurance contracts. As for the distinguishing elements of insurance versus investment contracts, it looks like they're going to be identical to the concepts that are currently envisioned under U.S. GAAP, so all the concepts that Mike talked about earlier would apply here as well. If you have a variable annuity, a fixed annuity, or a payout annuity that has a material mortality element, it would be covered by the insurance contract DSOP and it would essentially tell you to value the contract at fair value. There are two definitions of fair value. There's our traditional fair value: the willing buyer, willing seller type of value. If you don't have an established market, you would look at the present value of future cash flows, potentially, with some risk elements tossed in. And you would take into account the creditworthiness of the entity that's selling the contract to the insurance company.

There's also the concept, though, of specific fair value, which is basically fair value with a couple of tweaks. One is that you would look at the actual expectations of the entity. So for things like expenses, for example, you would take the expense structure of the entity that has the contract in determining entity-specific value, whereas the fair value would take into account what the market would believe you should be able to administer a product for. Also, an entity-specific fair value would use a risk-free rate for a discount rate as opposed to what might be done under a true fair value.

Finally, let's talk about variable contracts. So now we have contracts that don't have any material insurance element, they're variable contracts. Well, they're not covered anywhere, unfortunately, and the situation is quite unclear. If the death benefit is significant, you value it as an insurance contract under the DSOP. If not, then the DSOP is going to recommend that the board consider putting in some language to suggest that you follow the DSOP's guidance, which basically would mean a fair value-type of approach for variable annuities. But again, it's unclear, and in the absence of some direct guidance, it's kind of orphaned right now as to what you do with the variable annuities.

Let's recap a little bit of the landscape. You have this IAS 39 that tells you what to do with assets, and that's basically the U.S. GAAP approach. The IAS 39 tells you what to do with fixed annuities that don't have any sort of material mortality element. You value them on an amortized cost-type basis, like a book basis. You have your insurance contracts, and you value them on a fair value-type basis. And then you have your variable annuities, which you think you're going to do on a fair value basis, but it's not entirely clear. So you have all these little pieces that don't necessarily mesh together very well, and I'll talk about those inconsistencies in a minute.

But before doing that, I want to mention a couple of valuation points, just some random thoughts that are coming out of the guidance. First of all, for valuing the fixed annuity, there wouldn't be any reference to what the actual underlying assets are that are backing the annuity. Discount rates would be based on risk-free rates and, in particular, on an entity-specific basis it would be the risk-free rate. You could potentially have some adjustments to the risk-free rate if you're doing a true fair value. To come up with a fair value on a variable contract, you would use a risk-free rate as the projected growth rate as well, which is a little bit different from, I think, anything we're accustomed to. Cash flow projections and stochastic methods would be anticipated to be used for determining fair values. Expenses would include an allocation of overhead, and there should be adjustments for risk and uncertainty, although the guidance that's currently written gives absolutely no guidance as to how you come up with those adjustments. The general wisdom is that you would load either your discount rate or your projected cash flows to account for it.

This next item is probably the most important one of all. That is that there's a potential for significant gain or loss at issue on those contracts that are fair valued. On those contracts that are valued as insurance contracts, you could have a significant loss at issue, and for variable annuities you can see how that would happen. If you're pricing the annuity using some sort of expected market return, say nine or ten percent, but your projection of fund performance is defined to be the risk-free rate in the international standards, you would have a loss at issue. And then finally, there's a "whole contract" concept here. When you're valuing, say, a variable annuity, you have to look at the whole contract. You have to value it entirely. You wouldn't carve out pieces and value them separately.

Let's look at those inconsistencies. There's a disconnect between investment contracts, on the one hand, with the amortized cost method in insurance, and variable contracts with the fair value method. And there's a disconnect between asset and liability valuation. What is likely to happen is that the DSOP will propose a revision to IAS 39. IAS 39, again, deals with investments basically for banks and so forth. But the proposed revision would give insurance companies the option under IAS 39 to treat both assets and liabilities like trading assets, which basically means that you would mark them all to market. That would get rid of just about all the inconsistencies but it would introduce another inconsistency: banks offering similar products would be valuing their business on an amortized cost basis whereas insurance companies would be valuing potentially similar products on a fair value on a market-based basis.

It's awfully difficult to tell you all of the features here, and maybe the purpose of this talk is to just get you aware that there's a bunch of stuff out there and that as it comes down the road, it's pretty complicated and it's quite a different paradigm of accounting. There are parts of the DSOP currently on the FASB Web site, and you can see the details of them there. It's quite likely that the draft of the international standards will be exposed in late 2002 for comment, which would mean we would be looking at 2003 before the actual guidance for how to deal with insurance contracts is adopted. So the guidance is adopted in 2003, and in 2005 it's implemented. The time frames are pretty short.

**MR. O'CONNOR:** This is for my own purposes on the internal replacement issue of DAC. I assume this is going to be prospective only, so companies won't have to go back and redo their GAAP accounting for replacement programs they had in the past.

**MR. FRASCA:** There's nothing written, so we really don't know yet.

**MR. O'CONNOR:** There were a number of conversion programs from fixed to variable going back to '97-'98 that I was aware of. Hopefully, it will be prospective only.

**MR. ABRAHAM WEISHAUS:** My question is about the draft SOP for nontraditional long-duration products and something said in another session. I'll read from it: "Exposure draft released March 21, 2002. Final SOP due third quarter 2002." Here we said no exposure draft was released. Who's right?

**MR. O'CONNOR:** Nothing has been released yet that I'm aware of. It will be released by FASB. It was cleared by the AICPA in the ACSEC. So they did what's called a positive clearance back in March of this year. I think means it just got formally sent to FASB. Rob, is that your impression, too?

**MR. FRASCA:** Yes.

**MR. O'CONNOR:** There has been no draft SOP for the whole world to look at. There have been summaries of it on the AICPA website and other locations to look at it.

**MS. LAURA J. HAY:** Thank you for three very excellent presentations. I have a comment about the two views, with View A being the one that the task force is going to go toward, which has been agreed by ACSEC, as of the last meeting. I'm on the task force for the DAC internal replacements. View A is tremendously difficult from a practical side. I would hope that many of the insurance companies when looking at View A would comment when it becomes publicly exposed. If you have an internal replacement program that's a formal program, it's going to be easier, but if you have ongoing replacement activity, a few at a time, it's going to be an administrative nightmare. There's been a lot of debate, and that's why View B was even presented, but knocked down. So I would hope that View A gets a lot of thought from the industry as to how you practically do it.

**MR. O'CONNOR:** It's my general impression that the Academy Task Force on the C-3 Phase 2 had been requested by the NAIC to go down the path of developing a structure like the one used up in Canada for developing capital. I think I know some of the components of what the Canadian structure is for variable annuities, but it is my understanding that, at least for the RBC purposes, you potentially do a thousand stochastic scenarios using real-world assumptions, not risk-neutral assumptions. You would focus on, I think the NAIC is saying, the 90th conditional tail expectation, which is more or less the 95th percentile, and set your capital level according to the results of that stochastic modeling. If they include VAGLBs in that and then ultimately equity-indexed annuities as well, maybe that would be in 2004, I'm not sure. But I believe that's one of the things the NAIC is asking the Academy Task Force to do. Anybody have any comments on that?

**MR. RUARK:** I'll just add a little bit, although I'm not from Canada. One of the interesting aspects of that relates to GMIBs. What Mike said was that for RBC you'd use kind of best estimate assumptions. But, of course, for statutory reserving, you don't use best estimate assumptions. In fact, in the case of the GMIB, you assume that people will annuitize 100 percent if there's even the smallest advantage to them in doing that. As actuaries, we're accustomed to whatever your answer is for reserves, your answer for RBC must be bigger. Or, in some ways, RBC is a further measure. We think of statutory reserves at the 83rd percentile, RBC at the 95th. Well, GMIBs, and maybe there are other products out there with this pattern, are certainly a product where one could do a calculation of RBC and end up with a lower number than you do for a statutory reserve number. The key is that best estimate assumption, where very few people would say a best estimate would be that 100 percent of the contracts you write will eventually annuitize.

I like the conditional tail expectation (CTE) approach that the Canadians use. They use this rather than percentile because CTE 90 is the average of all the occurrences between the 90th and 100th percentile. If you have a linear progression between the 90th and the 100th, then, of course, the 95th is the same thing. But the expectation is that you will not have that but, instead, by using the CTE approach when your risk tends to be more exponential in nature, you would get a bigger number than the 95th percentile.

But back to the problem that the C-3 task force had. They wanted to do VAGLBs at the CTE 90 level, but when they layered in the reserving requirements, they went back and looked at whether adding the RBC to reserves changed the CTE point that you're at. The answer was always that it did, and by a great deal. A big part of that was that the assumptions that underlie both Guideline 34 and MMMM tend to be pessimistic in the long run. There's never any recovery, especially in the way that those types of programs integrate with CARVM. So that was what got the folks on the C-3 task force kind of scratching their heads and thinking that maybe we need to do more thinking here about how to integrate all of these things together.

So if you have a chance, take a look at the Canadian law that went into evaluating segregated funds. It was on the Web site. It's a very good read and very well thought out.