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Summary: GAAP remains a hot topic in the United States and internationally. The SEC and FASB have a number of initiatives that will change the landscape for public reporting by insurance companies in the future, including convergence with international standards, fair value reporting, accounting for nontraditional products, and consolidation of special-purpose entities affecting securitization. The panelists discuss these and other current GAAP reporting topics of interest to actuaries.

MR. MICHAEL A. HUGHES: Deborah Whitmore is clearly one of the foremost experts on U.S. GAAP in general and for insurance companies, in particular. She's a brilliant thinker, very knowledgeable about what's happening in the industry and in the professional bodies, such as the FASB and the AICPA and the SEC.

She's been on the SEC task forces that have developed a couple of the standards of practice (SOPs) that we'll be talking about today and has been in the trenches dealing with issues with the SEC. I have the highest respect for her insight as a professional.

Deborah is going to discuss the catchall basket of GAAP subjects. She's going to give you a feel for some of the other things happening in the GAAP world that might be relevant to actuaries. So, with that, let me turn it over to Jason.

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MR. JASON A. MORTON: My topic is the proposed SOP for the Nontraditional Life Task Force of the AICPA; hopefully by now you're all somewhat familiar, if not very familiar, with this SOP and what it's all about. It's been being kicked around and drafted and exposed and so forth for two, three, or four decades, it seems. But now it's real. It's gone through the exposure draft. It's due to be final any day. Second quarter is what has been stated, but we thought maybe even by this week—I haven't been on the AICPA Web site.

MS. WHITMORE: I'll give you the update. I had an e-mail from the Accounting Standards Executive Committee (AcSEC) chair late last night. The FASB cleared it for issuance at their meeting yesterday.

MR. MORTON: So it's real, and now you've got to deal with it. It's been on various presentations before many times, but now that it's real it becomes more important to understand the implementation here. That's what we'll talk about a little bit today.

Since we've got a lot of material to cover—and this is a fairly broad topic—we're just going to mention a few of the details regarding the valuation of liabilities, touching a little bit on sales inducements and some effective date transition issues. But we're not going to talk at all about the separate account considerations and disclosures at this point.

Why Cover This SOP?
Before we get into some of the details, let's set the stage for what this SOP is meant to do and why it exists. GAAP—or even more specifically, Financial Accounting Standard (FAS) 97—does not explicitly give accounting guidance for many of the products that are currently being sold today, products that weren't contemplated or weren't around while FAS 97 was being drafted. Certainly there was a need for some authoritative accounting guidance, and that was the nature for the SOP.

I think one of the reasons it took so long to get it to this point, where it's now being approved, is it was really meant to be broad, not just to cover product features that exist today, but product features that might emerge in the future. And you can imagine with that as your goal, it's hard to be very distinct and get things written down on paper that are going to apply to products not even contemplated yet.

Also because of that, one key implementation issue that comes out of that ishow do you implement something that isn't a very defined mechanical approach? So, you'll find there are more questions than answers when you start getting into the implementation.

Account Balance
The SOP does have some words about the account balance that is to be used as a GAAP reserve. It also talks about at least two other different types of reserves over

and above the account balance. I don't want to go into a lot of detail on this, but basically if multiple account balances exist, you'd use the highest one that would be available in cash today. So that clarified some questions around two-tier annuities, in particular, but also for some market value-adjusted annuities and products. And, just like any other account balance out there, there's no reduction for surrender charges, but also no adjustment for market value adjustments.

To the extent that FAS 133 would cover a particular contract or feature, 133 would govern, and you would deal with the embedded derivative methodology laid out in FAS 133. So that needs to be clear not just on this account balance definition but every other piece of authoritative guidance that comes through on this SOP.

Two Types of Liabilities
In addition to defining the account balance to use, there are two major types of liabilities that are discussed in this SOP.

Contracts that have death and other insurance benefits is the first. The other is contracts that provide annuitization benefits or benefits after annuitization.

Death and Other Insurance Benefits. For death and other insurance benefits coverage, the first thing you need to do is look at the significance of mortality and morbidity risk. You do this test, and if it looks like these features, these potential benefits, are insignificant, then you classify the contract as an investment contract. And if it's an investment contract, you're precluded from holding an additional liability over and above the account balance. You're done, no changes.

If, on the other hand, you do the test, and it looks like the mortality or morbidity risk is significant, you classify it as an insurance contract; then you've got to look at accruing a liability. To do that test, there's not much guidance on what that threshold is to define an investment or an insurance contract. You can refer to FASB 5, which asks if the probability is remote or not. You get some guidance from the term "significant", but basically companies have had to deal with this issue before with limited pay contract definitions and other things.

You're going to look to your team and maybe to your external auditor to discuss this test a little bit. But the test is probably going to be defined more or less in a ratio of the present value of the excess benefit payments over the total contract holder assessments or revenues, in other words, the excess benefits over and above the account balance that could be paid under various scenarios over the grand total of all revenues that would be collected under this contract. If that ratio is deemed to be significant, it's an insurance contract.

About the only additional information that the SOP provides to help you understand if this is an insurance contract or not is a line that uses the term "rebuttable presumption." It says basically if a contract does have significant mortality risk, it will have significant mortality risk due to the additional insurance benefit varying

significantly in response to capital markets fluctuations. And there, I think, they were specifically making it very clear regarding GMDB-type risk.

When you're doing this assessment, it's also made very clear in the SOP that you just don't take a single best-estimate approach. Instead, they're suggesting you consider a wide range of scenarios. It doesn't go as far as saying do a stochastic analysis—it does stop short of that—but it says look at a wide range of possible scenarios when you're doing this test.

And if this is an insurance contract, you must accrue a liability. The general theme here again is that you should accrue a liability to the extent you're collecting monies today that would result in the payment of benefit payments in the future. With that general concept in mind, the liability formula follows, which is basically to say, "Let's hold back a portion of those fees that we're collecting today and accrue a liability, because we'll need them in the future."

The additional liability equals the current benefit ratio times these cumulative assessments, grow them with interest, but then subtract off actual excess benefits to the extent they're paid (Chart 1). So it's a simple calculation. The key item to get at is this current benefit ratio. And you see this formula here. It's the total of the expected excess benefits over the account balance over the total assessments. The benefit ratio may exceed 100 percent in some instances, especially at implementation.

And, just like a deferred acquisition cost (DAC) calculation for a FAS 97 product, you true up with actual experience that's known. You periodically unlock your estimates of future assessments and excess payments. You true up this benefit ratio. Therefore, you true up the whole liability. And to the extent that results in a cumulative impact to the liability, you run that change through income, just like a DAC amortization true up or unlocking impact.

Now this additional liability, when you calculate it, can't be negative. If it is, you floor it at zero. The assumptions that you use, including the discount rate for doing present values, are all to be consistent with the calculation of DAC and the true up and unlocking that you need to do.

The other thing that I don't think a lot of people have thought about at this point is that this is a new liability to most companies. And if it is, to the extent that you are accruing this liability, you should take that change in liability into account in your DAC amortization stream.

Contracts with Annuitization Benefits. That's one general form of new liability from the SOP. The other is contracts that provide annuitization benefits; here again you are to establish an additional liability to the extent that the present value of expected annuitization benefits at the date of annuitization exceeds the expected

account balance at that date. If that's the case, you have to start accruing a liability.

It's very similar to the retrospective accumulation formula that you use for a guaranteed minimum death benefit (GMDB)-type calculation. It's a benefit ratio times cumulative assessments; grow it with interest, and subtract off actual payments—although this benefit ratio definition's a little bit different, as you can see.

And here was one of the most significant changes: As this SOP went through exposure originally, AICPA said the accumulation phase of a contract, like a variable annuity, is totally separate from the annuitization phase. So while you're in the accumulation phase you can't consider annuitization benefits. By definition you hold a zero liability. It just didn't make sense to me and a lot of other respondents. So, thankfully, they did change the SOP language, to have you accumulate a liability.

Again, the additional liability, once calculated, can't be negative. Assumptions are consistent with estimated gross profits (EGPs) that are used to amortize DAC. You true up. You unlock. You don't lock in the benefit ratio, for example. And then again you have to take the change in this liability into effect in the EGP calculation.

Sales Inducements to Contract Holders
A couple of points on sales inducements: Some companies have been holding these liabilities that I just mentioned, but many companies have been deferring these sales inducements, hanging them up on the balance sheet and amortizing them just like DAC. And the SOP came back and said "Let's continue that if you're doing it already; if you're not, you're allowed to go ahead and capitalize these costs."

If an agent knocks on your door, sells you a product and gets paid a commission, that commission is definitely capitalizable. Some companies felt pretty strongly that if they add an extra couple of percent to the first-year credited rate, that should be considered along the same lines as a commission. The company should be able to capitalize that as a sales cost and then amortize it over time instead of taking the hit all up front upon issue.

And that is the case, as long as this sales inducement meets a couple of criteria — incremental amounts over and above what you would normally credit a similar product without sales inducements. To the extent your credited rates for this product are higher, you can take that difference and capitalize it. And then also the amount that you capitalize should be higher than an expected ongoing rate.

Now, something that is in the SOP but seems a little bit suspect is that you are going to be required to have a product that has no sales inducements, and a like product that has sales inducements, in order to be able to capitalize these costs. The SOP says that, but according to some people on the task force, it might not be enforceable. But it's in there right now and needs to be considered.

If you're currently capitalizing costs, but all you've got is one contract—you don't have a like contract without inducements—you might want to take a careful look at that.

Companies that had been doing this in the past were treating it just like a DAC and amortizing it just like DAC. The major difference now is that you can't call it an asset, like a DAC. Instead it's a policyholder benefit, interest-credited. So you've got to put it on the liability side of the balance sheet. You'd amortize it just like FAS 97 DAC. There's no change there. And then the change in the balance comes through as amortization expense through benefits.

Effective Date and Transition

The SOP will be effective for fiscal years after December 15, 2003—which means 2004 if you're a quarterly filer, the first quarter of '04. Many companies are going to early-adopt from what I understand, which means they're going to be working on this and implementing it this year for '03, so effectively having to go back to January 1, 2003. As Deborah said, it looks like we're final on this SOP at this point.

Transition rules: Certainly this test that you use for significance for the death benefit and other insurance benefit liability needs to be done at contract inception and never changed or reassessed after that. But for implementation, you're certainly going to need to look at in-force contracts and make that assessment as of the implementation date.

The impact to DAC or these liabilities that you calculate still are run through income, but they're highlighted and flagged as a change in accounting principle. So they do hit income, but they get special treatment with footnote disclosures and so forth as a change in accounting principle. The last point is if you hadn't been capitalizing sales inducements in the past, upon implementation you can't go back and capitalize those amounts. You just do it going forward.

Where Do You Go From Here?

Given that this is real, and it's being adopted, and maybe your company's going to early-adopt, I'd recommend—if you don't know already—go talk to your controller or your CFO and find out what the company's intentions are. Are they going to early-adopt or not? And then right away start looking at implementation, especially as it relates to valuation systems.

I imagine that if you use vendor-based software this functionality might not be in there. Talk to your vendor and find out what will be in there and when. Also, take care upon implementation, because what you do now pretty much will set accounting policy for the future.

The other reason to look at this early is not just because of system mods and administratively getting the financial reporting process geared up for this. It's also to highlight what you'll find. There are a lot of implementation questions. The more

you dig, the more questions you'll find. The best thing to do is identify those early; there might be some additional guidance coming out. But at least you can talk within your group, maybe in some inter-company discussions and maybe with some of your advisors. Talk about some of these issues and implementation. The more you dig, the more you'll find. I can guarantee you that.

MR. HUGHES: I think one of the things that the industry and the companies haven't necessarily focused on much is the potential applicability of the guidance to universal life (UL) products with secondary guarantees, no-lapse guarantees, or variable universal life products with secondary no-lapse guarantees—GMDBs that are effectively no-lapse guarantees.

How do you see the guidance affecting that, and how should you look at whether or not you'd need to set up a reserve?

MR. MORTON: I've heard that question from a couple of companies, as well. If you look to the SOP itself, you can find some language, but even before you get there, the idea is this was supposed to cover features where there's not otherwise GAAP authoritative accounting guidance. So from that broad definition you would presume that this SOP should cover all those sorts of features, like GAAP reserves for secondary guarantees, for example.

If you do look through the SOP, there are a few specific paragraphs that actually mention no-lapse guarantees. They don't specifically say, "Just applies to variable annuities" or anything like that. So if you read the SOP, there are three or four paragraphs, in particular, that point out these sorts of things.

Where you've got a statutory reserve, like an AXXX or a no-lapse guarantee, my read of this would be that this would also apply, under the SOP, for GAAP. Is that consistent with what you guys have heard to date?

MR. HUGHES: Yeah, I think it is. But I think it depends on materiality. Some of the no-lapse guarantees have tended to be relatively short, at least some of the early ones, where it might just be a five-year no-lapse guarantee on a UL product or something like that. There's probably not much risk there, and it's probably not that relevant.

Some of the products more recently, both on the fixed and the variable side, have no-lapse guarantees that might go out –20 or 30 years, or to age 70 or for life or something like that. And the nature of those guarantees is that they're more valuable guarantees, and there's a nontrivial chance that those guarantees could get in the money at some point in time. So I think it's something that companies should look at and try to get a sense for whether or not they're going to be giving away free insurance due to these guarantees in later years. You could potentially need to set up a reserve.

MR. MORTON: OK.

FROM THE FLOOR: Couple of questions for Jason. First, where it says additional liability cannot be less than zero, I'm assuming that the restriction is at the portfolio level and not policy level. Is that right?

MR. MORTON: I don't know if it says, actually, in the SOP. I would guess it would be at the contract level, but it's probably open to interpretation.

FROM THE FLOOR: I think that it's not at the contract level.

MR. MORTON: OK.

MS. WHITMORE: I think I differ. I would say theoretically it's at a contract level, though I'm not sure how you'd ever do it at a contract level.

FROM THE FLOOR: But if it's at the contract level, then when there's a claim, there's no more contract. Do you mean a group of contracts?

MS. WHITMORE: A grouping of them.

MR. MORTON: Yes.

MS. WHITMORE: Yes.

FROM THE FLOOR: All right.

MS. WHITMORE: But it would not be like your entire life portfolio as a whole.

FROM THE FLOOR: When I said portfolio I was referring to a group of similar contracts.

MS. WHITMORE: That's how I would think of it.

MR. HUGHES: One approach to that would be to do it at the same level that you're calculating DAC, because it's a similar type calculation in a way.

FROM THE FLOOR: OK. You say it cannot reflect lapses in determining the amounts to defer; can you just elaborate a bit on why you mentioned that item exclusively?

MR. MORTON: To the extent that there's expected renewal, capitalized amounts that could come out of this. You wouldn't take the lapses into account as you're assessing those. So I don't know even to what extent this is going to apply.

MS. WHITMORE: I'll try to explain it this way: At this point you're talking not about the amortizing-the-asset side. You're talking about accruing for the liability side. Let's say this is like a persistency bonus. It's the perfect example. The assumption for accruing the liability on the persistency bonus, to be consistent with the FAS 97 model of an account balance, assumes everyone stays, as far as the account balance is concerned. So for purposes of accruing the persistency bonus itself, you're assuming everyone stays to receive that bonus. Obviously some will terminate and not receive the persistency bonus, and at that point, that portion of the reserve winds up being released.

MR. MORTON: The other thing I didn't mention is you can't forget about FAS 97 to the extent that some front-end fees come in for a shorter period of time than the benefits are expected to be paid. You would have a front-end fee just like you would as an unearned revenue reserve under FAS 97. None of that changes, either. So that's another point that's relevant as well.

MR. DAVID Y. ROGERS: Has anybody on this distinguished panel thought about the applicability of this accrual of an additional liability for where you're collecting premiums in advance of higher expected future claims and the applicability of that to a conversion option that's typically sold on a term insurance contract, where you would be able to convert to a universal life type contract without underwriting?

It seems like there might be some analogies that could be drawn even though the term contract would be FAS 60, but I'm just wondering if anybody had given that any thought.

MS. WHITMORE: I, frankly, don't remember there being discussion at the task force; although that project went on for about six years. So it's a little hard to remember every discussion.

I'd also be a little careful about extending this too far, because these will be volatile amounts. They are recalculated and trued up on a retrospective basis quarterly or at every reporting period.

MR. HUGHES: David, I think that's a good question. I wonder if you might not be able to provide for that even within the mainstream FAS 60 model, though, by factoring in the extra mortality as a cost potentially and locking it in. I'm not that close to the GAAP treatment on that, but that might be a possibility. Another variation on the theme is what about single premium whole life contracts where the cost of insurance (COIs) are waived?

MR. JOHN W. MORRIS: Jason described his talk as one in which he was going to discuss the real SOP. So I guess I'd have to describe mine as the unreal SOP. I think that's the way a lot of people have viewed it—DAC on internal replacements.

History of DAC Internal Replacements
I thought we should start with a brief history, and it is brief, because there's not a lot of GAAP guidance on internal replacements. First, Paragraph 26 of FAS 97 was the first time there was a prohibited DAC carryover when a traditional life policy was replaced by universal life policy. As you may remember, there was a lot of that type of activity going on when FAS 97 was first enacted.

There was an AICPA issues paper at the time that suggested that you would be able to not only defer the old DAC, but would also be able to defer the difference between the cash value of the original contract and the account value in the new contract. The AICPA argued that you were continuing the relationship between the insurer and the policyholder, and the only thing that was changing was the form of the coverage.

FASB rejected that approach and basically said that the DAC is associated with the contract, not with the policyholder. And so that's the sort of guidance we're dealing with in trying to determine what to do with DAC on internal replacements.

Practice Bulletin 8, which tried to clarify FAS 97, answered a question about whether that narrow guidance in FAS 97 should be interpreted broadly. The answer in Practice Bulletin 8 said that other internal replacements should be based on the circumstances of the transaction. Apparently not everyone fully understood the clarity of that guidance, because there's been some diversity in practice since then.

In 1999, the AICPA issued a discussion paper that contained three views. View A was that you would never carry over DAC. View B was that you could always carry over DAC. And in View C, you would carry over DAC only if the replacement contract was similar enough to the original contract. If I remember right, there were 11 responses to that discussion paper. Most favored View B or View C. The AICPA task force sort of took View C as their main focus.

Current Developments
So the AICPA formed a task force in 2000, and I am the Academy's representative on that task force. I thought it would be a short, interesting, learning experience, but we're three years in, and we're going to give a run to the Nontraditional SOP Task Force, who's going to last longer, I think.

Anyway, the direction that the task force got from the very beginning from AcSEC and FASB was to develop narrow fences, meaning that there shouldn't be a lot of contracts that qualify for internal replacements. So that's sort of what we were dealing with on the task force.

An exposure draft was released March 14 with a 60-day exposure period. I think the comment deadline was the 14th. We've gotten some responses. I think the last one came in over Memorial Day weekend. So, I guess the 14th isn't something the

AICPA holds real firmly to. I do want to say the Academy's response, which Mike Hughes had a lot to do with, was submitted on time.

SOP's Conclusions
So, what were the SOP's conclusions?

Definition. First, what would fall under the guidance of the SOP? What is an internal replacement? And the definition of an internal replacement doesn't mean that if you're an internal replacement, you qualify for DAC carryover. It just means that you're covered under the guidance of the SOP. And it's trying to deal with substance over form. That's why it's a fairly broad definition.

The obvious policy exchange—what we see a lot these days is the exchanging of one type of an annuity contract with another. We also include in the definition modification by amendment or rider—things such as adding significant benefits to a contract through the form of a rider.

The next item is the toughest sell, and that is election of a feature that's already in the contract. We found this in certain contracts. The one that comes to mind immediately is a variable annuity contract, which does not have a GMDB provision. But there's a provision in the contract that allows them to elect a GMDB at the then-current market rates. I guess the task force viewed that as being possibly problematic, because you change an investment contract to a UL-type contract with the election of a feature. There's probably a lot of discussion left on that subject.

"Not Substantially Different". Then the SOP tried to define what qualifies for DAC carryover and what doesn't. It came up with a concept called "not substantially different." Before I get into what that means, let me just quickly say what happens if you are not substantially different versus if you are.

If you're not substantially different, we deem the new contract or the rider as a continuation of the old contract. So we're saying there's been no issuance of a new contract, no termination of the old contract. So just treat it like a continuation.

So that means if it's a FAS 97 contract, and you're trying to do DAC amortization, then you have to marry the old contract's estimated gross profits (EGPs) with the new contract's EGPs to do the correct DAC amortization. That, I think, will be problematic with a lot of administrative systems or DAC amortization methodologies.

Substantially Different. If the contract is determined to be substantially different, then it's simply treated as if the original contract were terminated and the new contract was a new issue. None of the DAC from the old contract is accounted for under the new contract.

To be not substantially different, there are four requirements, and you have to pass all four of them.

One of them says that you don't change the inherent nature of the contract. So later on we'll determine what inherent nature means. If you charge money to effect the transaction, it meant that it was an issuance of a new contract. If in the old contract you charged a surrender charge and you're bringing less account value over to the new contract, then that was an indication that it was a new contract and not a continuation of an old contract.

The fourth item was no change in the amortization methodology or revenue classification. That basically indicates that you're changing accounting models from FAS 97 to FAS 60 or vice-versa. I don't think we were allowed to use those exact words in the guidance, but we figured if you're changing GAAP models, that was a clear indication that the products weren't substantially similar and that you would treat them as being different contracts.

So the SOP then tries to define what is the inherent nature of a contract. There are three criteria.

First, the type and degree of mortality risk is the same. We talked about mortality risk in an annuity contract versus a life insurance contract. They both have mortality risk, but that's a different type of contract.

A similar criterion exists with morbidity risk. If you're trading in a hospital indemnity for long-term care, that is different types of morbidity risks.

The third item was investment return rights and provisions. Basically that means that, in the example of an annuity, if you're getting a credited rate that's at the discretion of an insurance company versus an equity-indexed annuity where it's more formulaic, or a variable annuity where it's more of a pass-through, we determined that they were substantially different contracts. The rights of the policyholder under those different contracts were substantially different with respect to how credited interest was applied to the contract.

Not in the base of the SOP, but buried in the back in the basis of conclusion, they talk about re-underwriting. And that should be a consideration. I think if you're going to re-underwrite an entire contract, that's probably a pretty clear indication that it's a new contract and not the continuation of an old contract.

Some Things Don't Change Inherent Nature

A couple examples of what the task force believes do not change inherent nature—these would qualify for DAC carryover:

New investment options: We already had multiple investment options. That seems fairly straightforward. Second one is modification and general account deferred

annuity with a declared interest rate of 5 percent, changing it to an market value adjusted (MVA) with a declared interest rate of 6 percent. This is obviously an old example, isn't it? The task force thought that what you're changing here is not the investment rates and returns. You're just changing the surrender benefit provision of the MVA.

Modification of deferred annuity contract to include long-term-care benefits was thought to be OK, as long as the long-term-care benefits didn't become the primary benefit. We tried to define primary benefit as the most significant, but not necessarily the majority of the benefits.

MR. HUGHES: One of the types of internal replacements that I think companies focus on a lot isfixed annuities as they reach the end of the surrender charge period or near the end of the surrender charge period. They might want to try to roll them onto a new contract with a new surrender charge and perhaps a new interest rate guarantee. Would the existence of a new surrender charge impact the classification?

MR. MORRIS: We didn't think introducing a new surrender charge to a contract would affect the inherent nature because it didn't change the mortality or morbidity risk, and it didn't change the investment income rights. It basically just changed the surrender benefit at the end of the accumulation period. So adding new surrender charges would not disqualify you from carrying over DAC.

Adding a GMIB to a variable annuity contract was thought to not change the inherent nature. Again, that doesn't affect the accumulation period. It affects the payout period, which, I guess, we deem is a different contract.

MS. WHITMORE: At least we thought that it didn't change the contract.

MR. MORRIS: Yes. Examples that do change the inherent nature: exchanging a term insurance contract with a whole life contract. There, the mortality risk is probably the same. It's the investment nature that has changed significantly.

Adding a GMDB provision to a variable annuity was one that there was quite a bit of discussion on. We thought that that would change inherent nature because you're changing from an investment contract to a universal life type contract.

Replacement of a separate account product with a general account product: I know a lot of comments we got even before the SOP was drafted was that this is something that should not rule you out. But the AcSEC voted pretty heavily that this was a significant change and that the types of contracts were based on the interest crediting and who's on the risk for the interest rates.

Similar replacement of a general account annuity with an equity-indexed annuity: That goes with the example I gave earlier of changing it from interest being credited at the discretion of an insurance company to the one that's more formulaic or tied to an index.

Other Considerations
Other considerations: Riders attached to existing contracts—GMDB is an example of that that we've spent a lot of work on.

New deferrable costs: If you incur additional commissions or additional issue costs, as long as things are recoverable, and you qualify for internal replacement, the current draft SOP considers that as a reasonable thing to add to your existing DAC.

The SOP also applies to unearned revenue liabilities and sales inducements and, to the extent that it's applicable, to GMDB liabilities that the new SOP dictates.

Transition was prospective only. You don't go back and do anything.

Disclosures: We're recommending just very minor disclosure—just what is your corporate policy on accounting for internal replacements.

The current SOP would be effective in 2004 if adopted the way it's currently written. My personal feeling is that probably won't happen, but that's my own personal feeling and not that of the task force.

Academy's Response
The Academy, as I mentioned, issued a response. There are a lot of suggestions in the Academy's response letter. They thought that the SOP was too rules-based. In this atmosphere of trying to get principle-based accounting, they thought that these were just adding more rules with not enough principles behind them.

The Academy pointed out that the SOP ignores some fundamental nature of transactions. One of the things the Academy pointed out was that we don't look at first-year commissions. If you pay a first-year commission on a new contract, that does not disqualify you from being substantially similar and carrying over DAC. But paying a first-year commission in a lot of people's mind would cause you to believe that it is a new contract.

The Academy pointed out several examples that would require DAC write-off where that didn't seem to make economic sense based on a transaction. The biggest item is that even though there is diversity in practice, and it is a problem, it's not an Enron-type problem, but the cure, as it is currently written, is much worse than the illness. And that is a point that I think will be well-received by the task force.

The other thing is the definition of the internal replacement. It was pointed out by the Academy that it's a very broad definition. The way it's worded, people are

reading into it a lot more than the task force ever intended. Some people think that if you submit a change in beneficiary or do a partial withdrawal that you're now an internal replacement. I'm sure that's not what was meant by the people that drafted the SOP.

Where To From Here

So where do we go from here? On June 11 the task force will make a presentation to AcSEC. AcSEC is the executive committee of the AICPA.

MR. HUGHES: Any sense, Deborah, for the current direction, or are you waiting for the June meeting?

MS. WHITMORE: Well, we will certainly look to AcSEC for their guidance on how they would prefer that we try to proceed. We will not be going into AcSEC, by the way, with a complete analysis of every comment, simply because that's a very detailed process. We actually go through and prepare for AcSEC an analysis of every comment from every letter and then what we would propose to do about it. That's probably going to come up at a later meeting.

The task force is an all-day meeting, and we said that there are two threshold-types of questions to deal with, and that's what I would call the scope and the direction.

Do we try to tinker with what we have right now? I don't think any of us meant partial withdrawals as somehow negating the contract or anything. So when we think of "Will you reduce the balance?" we didn't think of "You reduced the balance because you gave it to the customer" as being a problem. We only thought about reducing a balance and *not* giving it to the customer. Now that's a problem. So that's the kind of thing we can fix. I don't think there's a lot of dispute. Do we do that or do we try to, you know, react to the comments in a different way?

The Academy letter I think is certainly viewed by many of us as being a fairly negative letter. The ACLI letter is also a negative letter. Most of the others are probably somewhat less negative, but they do raise some questions about eitherthe reader's understanding of what we thought we were trying to say or some questions about did we really capture the right issue here? So those are threshold questions we'll try to get AcSEC to give us some direction on before we try to go back and start drafting on the document.

I think it's the ACLI that suggests that the project be terminated. The first question we'll ask is "Is that what AcSEC would like to do?" We feel pretty sure the answer on that is probably no. Then we go to the next question of "Do we need to rethink the whole approach and go to something more simplified?" Every amendment will result in a new contract. There are lots of ways you can go on this. I don't think that's the task force's desire, but we'll raise the question. So I suspect we'll be back to redrafting as the summer progresses.

MR. HUGHES: Thank you, Deborah.

I think that particular example illustrates some of the complexities of trying to write guidance that is general enough to cover all different types of situations without causing unintended issues elsewhere. That's a tough one to deal with and a tough one to fit within the sort of existing guidance, as well. There is precedent out there that's not particularly generous in terms of what we might like to do.

Now I'll turn it over to Deborah for some other topics.

MS. WHITMORE: I'm going to try to cover a broad array of topics in a relatively short period of time.

I'm not, unfortunately, going to be able to cover any of these in any particular depth. I will also tell you that I've organized those slides in two ways. The first part's going to be the slides that I'm actually going to talk about today. The back of that's going to be a whole bunch of other slides on these topics that I thought somebody might find interesting, and since I couldn't go into a lot of detail on them, I thought I'd throw them in. So, that'll give you a little more background on this.

The topics that I'm going to touch on are a couple of things that are going on down at the SEC. Some of these are actual rules that have now been finalized, some of these are simply proposed rules.

The SEC hot buttons are really some of the topics that we're seeing coming up in comment letters, in particular. They are the things we thought you might like to know about: other-than-temporary impairments, including what's going on at the emerging issues task force (EITF) with DIG Issue 0301; FIN 46; and FAS 133, DIG Issue B36. A number of these topics, as much as anything else, we just thought perhaps people in your company are talking about them, and you'd just like to know a little bit about them.

Goings-on at the SEC

2002 was a tumultuous year, to say the least. The scandals that began to emerge culminated in the passing of the Sarbanes-Oxley in July. Not too long after, I think the betting was that there would be, in fact, no massive reform. The SEC has now spent the time since then coming up with final rules—the rules that they're required to put in place to implement the guidance. They've been very busy. They've also had to deal with their own internal scandal around the appointment of the public company oversight board, and that actually resulted in the resignation of Chairman Pitt, as well as Bob Herdman.

We now have a new SEC chairman confirmed, William Donaldson, one of the founders of Donaldson, Lufkin & Jenrette. Some of you who know my history know that I was at Equitable, which at one point owned DLJ.

Other than that, let's talk about a few of the things that they've passed: I suspect some of you have heard about non-GAAP financial measures. In July, the SEC published their rules that are intended to implement Section 401(b) or Sarbanes-Oxley, and that had to deal with the disclosure of pro forma financial information. One of the things that the SEC did in coming up with the final rules is changed the wording from "pro forma" to "non-GAAP" to differentiate this guidance from the guidance that applies to pro forma earnings requirements that are already in the SEC requirements.

Basically what this says is any time a company provides a non-GAAP measure, it has to reconcile that to the closest GAAP measure. It essentially has to explain in an SEC document why management uses it. There are a lot of new requirements around the use in either a press release or in an SEC document of a non-GAAP financial measure.

"Operating Income" Out. First, one key thing I wanted to mention is that you probably will no longer be using the phrase "operating income." They are extremely sensitive to the phrase "operating income," because that does get confused with what in the ordinary corporate world is an actual, real, live, honest-to-God GAAP number for operating income.

"Operating earnings" doesn't win a lot of favor. As the AICPA Insurance Liaison Task Force, we, along with a number of companies and a number of the firms themselves, have had some discussions with the SEC about "Exactly what do you mean with these requirements?" Essentially we were asking the question, "The insurance companies have this number of operating earnings that's very widely used, and it's widely used by the analyst community. That's OK, right?" The SEC more or less responded it would be willing to discuss this with an individual company, but it was not willing to give a blanket endorsement, in part because we had to admit people define this number differently.

So most of us are encouraging clients "If what you were doing as operating earnings was, in fact, net income backing out the effect of capital gains and losses, then call it earnings before capital gains and losses or earnings before investment gains and losses. Even though it's a long, convoluted term, it's less likely to get you in trouble."

The other thing is, you can use a ratio. Statutorily based ratios are fairly common in the insurance industry and used in GAAP disclosures or in SEC documents. You can use it, but only if, in fact, it is the literal ratio that is used in a regulatory document. Otherwise, it is most likely to be another non-GAAP financial measure that would require reconciliation. But to the extent that it is a ratio published in a regulatory document, a statutory-basis document, then it does not actually require the reconciliation.

The SEC staff is currently working on a Q&A to this whole Reg G issue, and they have promised that many of these issues will be clarified when Reg G comes out.

Internal Control. Another Sarbanes-Oxley topic is internal control and, in effect, 404.

One of the new things to tell you is they finalized this rule Tuesday; the thing that changed in the finalization of the rules was a deadline for implementation starting September 15, 2003. Now the deadline is June 15, 2004. The reporting will not be required for 2003. It will be required for 2004. There's a small-company exemption that gives a delay, I think when you're less than $75 million in market cap. And there's also a delayed implementation date for foreign private issuers.

Essentially what this requires is that management report on its internal controls as they relate to the preparation of financial statements and financial information. There is also a requirement that the auditors opine on management's assertions as to internal control.

Ongoing SEC Work

After Enron, the SEC staff started a process of reviewing the financial statements for the 500 largest corporations. At the last update to their Web site that I saw, they had completed approximately 350 of those and issued comment letters. They were still in the process of clearing comments and looking at the other 150.

If you're really interested, you can get this information off the Web site. I assume all of you know their Web site, www.sec.gov, and you probably go there every day to see what's new, right?

There have been a lot of issues that they identified in this review. I actually included within the background materials a listing that I think is fairly complete of everything that they had, but I'm only going to talk about a few of them.

I'm going to talk about MD&A, critical accounting policies, and other-than-temporary impairments, because those are probably the issues that they've raised that are most applicable to the insurance industry.

MD&A. They looked at MD&A, and what can we say, other than they are not happy?

They don't believe that many registrants are complying with the existing SEC rules. They don't think the forward-looking information is particularly well done; companies are neglecting to discuss information when there are known trends, uncertainties and other factors that are reasonably likely to occur and would have a material impact on the financial statements.

They've issued a significant number of comments within this process, as well as their normal comment letter process, looking for a great deal of additional analysis or specificity to the company's analysis of what's going on with financial conditions, the trends, etc.

They feel that many of the discussions that they are seeing are, in fact, too boilerplate; they are not company specific and they don't represent a good analysis of what's really going on. The MD&A discussion is still much too much "It went up; this went down; it increased 12 percent; it decreased 13 percent," without a real discussion of what the business factors are that are driving these results.

The other thing they are not happy about is they don't feel companies have disclosed the information that would be required relative to changes in estimates, ranges, and those types of items.

DAC Questions. The other thing we have also seen a lot of comments on lately is they are beginning to ask lots of questions about things like DAC and DAC assumptions and EGPs. Where companies have disclosed a change in DAC as a result of assumptions, we have seen the questions come in that seem to be aimed at "Why now? Why this quarter?" And the questions go along the lines of "Tell us every assumption that you evaluated. What was your basis for making a change? What other assumptions did you consider and reject, and why? What are you still considering and have not yet reached a decision about? If you changed your DAC assumption, if you lengthened the life, why? If you changed persistency assumptions, what was the basis for that assumption?"

Mostly what they were picking up in their comments relative to FR 60 is that they are not satisfied that companies are doing as good a job as they would like to see dealing with potential variability, what the potential range of results might be. In general, many companies have not displayed ranges in sensitivity analysis, and we're seeing some comments pushing for that.

Accounting Policies. Critical accounting policies: We, not too terribly long ago, looked at a very limited number of life insurance companies, just to see what kinds of things people were disclosing. These were actually the nine largest public life companies. No surprise—pretty much everybody thought future policy benefits and DAC were probably among their critical accounting policies.

Investments: The issue there is primarily impairments, as well as some discussion around determinations of fair value when there is not a deep public market.

Other-than-temporary Impairments. Both from their review of the Standard & Poor's (S&P) 500 and other comment letters we've seen, the SEC continues to focus on other-than-temporary impairments. Some of this is really a result ofwhat's gone on in the market. We continue to have negative results in the market from the standpoint of equity performance, as well as on the credit side. We are in one of the

worst default cycles and restructuring cycles on debt since the Depression, and that's showing up. So, there are lots of questions around other-than-temporary impairments.

Time Underwater Significant. One of the things that we are seeing is that the SEC is focusing increasingly on this idea that as the time of underwaterness increases, the time itself becomes by far the more significant determinate of whether there is an other-than-temporary impairment.

The actual guidance itself is very judgmental, but the application from the SEC seems to be pushing very much at this ultimate, at least for equities, 12-month bright line. It is very difficult in a debate with the SEC to convince them that an equity security that's been underwater for 12 months has any chance of recovering in a near-term period.

Goings-on with FASB, EITF
I'm going to talk about some things that are going at the FASB and the EITF. What a surprise! OTT.

0301. There's an EITF issue for those of you that have been following it, 0301, that has now been discussed two or three times. It started out as an issue to deal with other-than-temporary impairments when dealing in the world of an Actuarial Practices Bulletin (APB) 18 equity method investment. Then it expanded to be other-than-temporary impairments when dealing with any kind of investment at all.

There are basically three views under discussion. View A is a three-step process with a bright line at one year. View B is a three-step process with a rebuttable presumption, if it's been underwater more than one year. And View C is a much more judgmental approach based on facts and circumstances.

The early discussion at the EITF itself led to the formation of a working group to try to come up with guidance. They were initially told to come up with a model that would work for every type of investment that was not already covered. So they were trying to cover FAS 115 equity investments, 115 debt investments, as well as APB 18 equity method investments, and if anyone ever had —not that we really would in this group—some old cost investments under FAS 12.

Three-step Process.
First, is the fair value of the investment less than cost? If so, that investment is impaired. There are two steps under one. One is if there's a public quote, you're going to use a public quote, period. The second step would be if you had an investment for which there was, in fact, not a readily determinable market value—there you're talking primarily about equity investments in which it's a private placement—and there is, in fact, no public market in the security, that you would have an approach that said "First you looked for whether or not there was an indicator of an impairment. And if there was an indicator of impairment, then you

had to get a fair value for that security." Then you would compare the fair value, and if it was less than cost, it's impaired.

In every situation in which market is less than cost, you fell to the second step, which is "Was that impairment temporary?" Theapproaches that are under discussion will tend to have pretty much a 12-month type of view when it comes to equities. It's not like it's non-rebuttable, but as one of the task force members said, it's almost like in the SEC's view, for a security that's been underwater 12 months to not be impaired. Pretty much God's going to come out of the sky and tell you about that investment. So, you've got to pretty much assume underwater 12 months is going to be impaired.

FROM THE FLOOR: Does the percent underwater matter?

MR. WHITMORE: No. A dollar underwater is underwater. But then, if it's only a dollar underwater, the impairment's only a dollar. Percentage would not matter in this scheme.

Now, the next step would be, once you've concluded whether it's temporary or not, that would take into account the likelihood of a near-term recovery in the value when dealing with an equity security. By the way, the 12months is not a safe harbor. The SEC's been very clear on that. They would expect it to be looked at much more quickly than that. But that 12 months is really in the SEC's mind still being discussed as the last possible day; they would expect most impairments to be recognized once a security had been underwater for six to nine months.

If you were down the path of a debt instrument where I think they are likely to stay, when it comes to a debt instrument, the first question is "Is it probable that that borrower will make every principal and interest payment in accordance with contractual terms? And does the holder have the ability and intent to hold to maturity if necessary?" A lot of the task force had proposed a somewhat gentler standard than the ability and intent to hold to maturity, something closer to—I think it's D94 that says it—a lack of present intent to dispose of it.

At the last EITF meeting, the SEC observer commented rather strongly that they believed a company would have to have the more positive ability and intent to hold the security to go down this path. And we think that where it'll finally come out will be that it's the probability that the company will pay, even though much of the language that seems to get used is along the lines of on the debt security, that there has been no change in the credit risk associated with the contract or that any change in value is purely due to interest rates.

But we actually think what'll come out was probably a recognition thatdowngrades, certainly within the investment grades of bonds, and changes in credit spreads—remember, in the FASB's view, credit spreads are credit related, not interest

related—when dealing with investment-grade securities, will not trigger an impairment. That will, of course, remain to be seen with the final guidance.

If you've concluded that the declines are temporary, then you write the security down to fair value.

FIN 46
FIN is FASB interpretation, and 46 is its number. Its name is Consolidation of Variable Interest Entities. So you want to remember the phrase VIE and variable interest entities.

This is currently applicable to any new VIEs that were created after January 31, 2003. It will become applicable for public companies, in effect, in September and at that point will be applicable to all VIEs.

So let's talk about what this thing means.

FROM THE FLOOR: What are some of the other names for VIE?

MS. WHITMORE: VIEs are new—it's our new name. We used to have SPEs and special purpose vehicles (SPVs) and SPREs. We're not going to have those; we're changing their names. They're now going to be VIEs.

What Are VIEs? VIEs encompass a variable interest entity. Let's walk through the decision tree for a second.

Entities get divided into two things now. If it's a voting interest entity, whoever is supposed to consolidate it is determined based on who has the voting interest. The easiest way for us to think of it here, because we're not going to go into all the details, is to think of it as a real company. It's got enough capital and equity to go off and do whatever it's supposed to do, and nobody that's invested in it is responsible for its care and feeding. It's a real company. Met's a voting interesting company.

And if you're a voting interest entity, then whoever has to consolidate it is determined by who owns the majority of the voting interest, and that's essentially today's rules.

If you're not a voting interest entity, then you must be a variable interest entity, because the world's only got those two things now. And if you're a variable interest entity, what you essentially have to figure out is who the primary beneficiary is. And the primary beneficiary is whoever has the majority variable interest. It's got nothing to do with votes. Is there a party out there that has the most significant exposure to loss or the most significant—exposure not being exactly the right word, but I'll say exposure—to gain? Who is going to get the chance of the upside? Who is

going to get the chance of the downside? And if there's a tie with different parties having upside and downside, the downside guy consolidates.

What Do You Do About It? What are the kinds of things that you want to do? First you've got to identify all the entities that have to be evaluated. And for insurance companies, there can be a lot of entities.

Those things that you've got invested, like collaterialized mortgage obligations (CMOs) and CDOs and things like that, those are probably all VIEs. So there is a very real chance that someone may have to consolidate; certainly they have to be looked at to determine if someone has to consolidate it.

So first you've got to figure out all the possibilities of the entities that have to be evaluated. Some things that you consolidate today, you may not have to consolidate in the future. The one that I've run across probably the most often is where you've got the structured European medium-term note programs, structured GICs, structured funding agreements. In general, most of those SPVs are being consolidated by the insurance company that issued that particular funding agreement or GIC. Those are probably not consolidated entities anymore under FIN 46.

You may not get very different answers, given how they've typically been consolidated. But you have to look at what you're consolidating today, because you may not have to consolidate them in the future.

You also have to look at anything in which you have a variable interest, because you may have to consolidate those. You have to get the information that you need to reach the decision as to if there is a primary beneficiary, who is that primary beneficiary, and to get the information that you would need to be able to actually implement the accounting. Of course, all of this will be subject to Sarbanes-Oxley 404.

DIG Issue B36

This issue's been floating around now since about the summer of last year, when Annuity Life Re put out a press release saying that in discussions with the SEC, they had reached the conclusion that all of their vanilla modified coinsurance (modco) and co-funds withheld treaties contained embedded derivatives, and they would be restating to bifurcate those embedded derivatives.

The ultimate outcome from lots of discussions that went on around the industry, the profession, both with or without the SEC at different points: In April, the FASB cleared DIG Issue B36. It basically deals with this issue of whether or not, when there is a credit risk that's unrelated to the risk of the obligor under the debt type instrument, that's clearly and closely related. The conclusion from the FASB was that that is not clearly and closely related when it's only partially related to the

creditworthiness of the obligor or even unrelated to the creditworthiness of the obligor.

This guidance will apply obviously to most modco and co-funds withheld treaties in which the ceding company is a U.S. company, because to comply with the statutory requirements for risk transfer in Appendix A791, you have to pass through the actual investment performance of the portfolio that's backing the contracts when you're dealing with life contracts, annuity contracts and those types of things—anything with a significant investment component.

It will also apply to things like credit-linked notes. It may apply even to reinsurance contracts that have been done on a coinsurance basis if, in fact, there's an experience refund provision that utilizes actual performance.

I say actual performance. Even if you had an instrument that was tied to an interest rate index, that gets called if that interest rate indexis a total return index or it contains anything to do with credit exposure. Lehman Corporate Bond Index is a total return bond index. It passes through credit losses, as well. The only time you will not be caught by B36 is when, in fact, either the portfolio is composed entirely of Treasuries so there is no credit exposure at all or if your portfolio were composed entirely of, for instance, real estate (a non-financial asset), because that already has an existing 133 exemption.

This is effective for the fourth quarter of 2003. I suspect most companies will not have documentation in place or will not even push to have documentation in place on October1. There's no particular reason to, but it will have to be applied by the end of the year.

Implications for Companies. What happens is that you'll have to identify the embedded derivative, bifurcate it out and account for it at fair value, unless it's used as a cash-flow hedge. Our DIG and FAS 133 people have told me that they essentially think there will be no one that can meet the criteria for qualifying to use this as a hedge, but I put it up anyway.

This will definitely result in more volatility, because you'll have the change in the fair value of the embedded derivative going through the income statement.

If you're on the ceding side, and you've got these embedded derivatives and your modco treaties or co-fund treaties, you will be allowed a 115 Mulligan—that is, you can transfer 115 securities out of available for sale or held to maturity and into trading, no more than the amount related directly to the derivative you're having to bifurcate out. They also must have the same characteristics as the securities related to the derivative that you're bifurcating out.

On the ceding company side, the Mulligan may, in fact, be useful in some circumstances. It could permit the company, assuming they can manage the whole

process tightly enough, to designate a portion of their portfolio of securities as trading to mitigate, so that the change in the market value of the trading portfolio will mitigate the impact of the change in the fair value of the embedded derivative they have to bifurcate.

Implementation Steps: As sort of an overview, first you've got to figure out every contract that has to be evaluated, find the embedded derivatives and identify the embedded derivative, because the DIG issue doesn't tell you the nature of the embedded derivative. Now, I will say that the two prime candidates for an embedded derivative would be some type of credit derivative or some type of total return swap.

You also will have to identify the host contract. Now, the thing about our contracts is it's not so clear with the nature of the host as to whether or not the host contract is inherently a fixed-rate host or an inherently a variable-rate host. "What is the embedded derivative?" may also imply "What's the nature of the host?" You then have to develop the approaches for valuing the embedded derivative.

MR. HUGHES: Very good. Deborah, if I'm an actuary, and I've got my FASB statements and my Actuarial Standards of Practice, with a little bit of luck I could find an EITF and an SOP and something like that. But is the SEC promulgating more guidance directly all the time? As an actuary, where would I find that? Can we expect guidance coming out of the new Accounting Oversight Board? –Where should we be looking for some of the new standard setters?

MS. WHITMORE: Coming out of the Accounting Oversight Board will actually be auditing guidance, as opposed to pure accounting guidance.

At this point, the SEC has said that accounting guidance will remain at the FASB; that is, of course, subject to the SEC's oversight. That's been the case, by the way, for a number of years.

The SEC issues guidance, but in subtle ways. They've tended to do it by statements made at speeches, by the comment letter process itself, sort of picking on a registrant and banging on them until they give up, and then go into the next one and attacking them on the same point. They, by the way, recently issued a new Staff Accounting Bulletin that takes all of their previous staff accounting bulletins and brings them all together. I think it's SAB 103, but I'm not sure about that. My understanding is that there were no substantive changes in their guidance. They simply codified everything that they had.

The FASB will continue to issue accounting guidance. Other than completing the projects that are underway, the current intention is that the AICPA will no longer be issuing authoritative guidance once it finishes this round of SOPs. It will, however, continue to issue accounting and audit guides. They're not Level A, but they are, in fact, in the hierarchy of accounting guidance. We say, well, you're no longer going

to issue statements of position, but they will continue to issue accounting and audit guidance that will have the effect, frankly, of being accounting guidance that would be expected to be followed.

FROM THE FLOOR: You mentioned something you called non-GAAP financial measures. Does that include things like lapse rates and sales audited kinds of financial ratios? Or is it really financial statements? Those show up in SEC statements.

MS. WHITMORE: Those are not within the scope. In general, that type of information is not within the scope of that guidance because it's not considered to be financial information, if you will. It's of a more statistical nature.

Where the questions, though, will come up is now you've got to tell people what you mean by "sales," because that's not a concept we have. If you use statutory definitions, then you do get into the question of what have you defined this as being. And you would be expected in an SEC document to tell the reader how you're using the word "sales," because that is actually not a word that has a common meaning in the insurance industry. We don't believe, subject to this Q&A that clarifies the world, we don't think that is what they mean.

However, if you're going to disclose premiums, then it needs to be premiums as defined in GAAP. If not, you've got to say how you're defining premiums and reconcile that to premiums as it's used in GAAP. That is a word that has a GAAP meaning.

MR. HUGHES: Why don't we declare a victory? I think we're done. I told you we had a good panel. Let's give them a hand.

Chart 1

Valuation of Liabilities

Contracts with Death or Other Insurance Benefits

- **Additional liability equals**
  - Current Benefit Ratio x cumulative assessments
  - Less cumulative excess payments and related expenses
  - Plus accreted interest
- **Benefit ratio equals (determined over the life of the contract)**

$$\frac{\text{PV of total expected excess insurance payments and expenses}}{\text{PV of total expected assessments}}$$

- **Benefit ratio may exceed 100%**
- **Use historic experience from issue to valuation date, and expected experience thereafter**