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Summary: This open forum focuses on emerging U.S. GAAP accounting issues, with emphasis placed upon implementation issues encountered by affected companies. Topics to be covered include Statement of Principles (SOP) 03-1 on nontraditional long-duration life insurance contracts, SOP on internal replacements and the impact of Derivatives Implementation Group issue B36 on embedded derivatives for modified coinsurance and funds withheld reinsurance.

MS. PATRICIA E. MATSON: I'm Tricia Matson. I'm from Deloitte. We're going to cover three topics today. We're going to cover Derivatives Implementation Group (DIG) issue B36, the SOP and the draft SOP on internal replacements.

Speaking with me today is Carol Salomone. She works at Allianz Life Insurance Company of North America. She's an FSA and chartered financial analyst (CFA). She is currently a vice president in the risk management area, and she's been with Allianz for approximately eight years. Before that she worked for 15 years at Lewis & Ellis.

Also with us is Darin Zimmerman. He is with AEGON and is an FSA, as well. He works in the corporate actuarial area out of Cedar Rapids. He has 15 years of experience as a life actuary and has worked in diverse areas. He was with a mutual with a smaller company, was with a consulting firm and now is with AEGON. He is responsible for GAAP reporting and for implementing Sarbanes-Oxley. I'm with

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Note: The charts referred to in the text can be found at the end of the manuscript.

Deloitte. I've been there for a couple of years. Before that, for approximately 10 years, I was at Andersen.

I'm going to turn it over to Darin to cover DIG B36.

MR. DARIN G. ZIMMERMAN: When we have these sessions there is always a wide range of experience, and you never know exactly what level to take. I've decided that because B36 is probably well-established and there's not that much new, the experts who are up to their eyeballs day to day in this probably aren't going to take a lot of this in. I'm going to do what would be a general review for those newly to moderately involved. It will be fairly detailed. I'm also going to go more quickly than I thought because there's some breaking news related to the SOP, and I'm going to try and leave some extra time at the end for that.

I'm going to be talking about the background and history, and I can never resist the opportunity to editorialize. People who know me know that. I'll cover implementation options and mechanics and have a quick numerical example at the end.

FAS 133 is the next step after FAS 107 and FAS 115 and is transitioned to fair value accounting. The powers that be feel that fair value accounting is better than capitalization and deferral, so that's where we're going. It's a painful transition, as you can imagine. Every transition is painful. It's the wave of the future, it's coming, and resistance is futile. You will be assimilated.

The history for this specific topic, B36, is interesting. I forget the gentleman's name, but a gentleman at the SEC was surprised to find that insurance companies didn't obviously know there was an embedded value in modified coinsurance (modco) treaties. When he was talking with the members in the AICPA, he was saying, "That's not a big deal. Insurance companies can restate their last three years and fix this." Through some negotiations, the AICPA was able to convince the SEC that going back wasn't going to be all that productive and got it to accept that merely fixing it in the future would be acceptable; we wouldn't have to go back and restate.

The reason there is an embedded option in modco treaties is because a treaty is basically a contract that stipulates a series of settlements, a series of cash flows. Those cash flows are dependent upon the actual asset performance of the modco assets. The proper way to think about this is that a modco treaty is a coinsurance treaty, and all of the risks and all of the assets transfer from the ceding company to the assuming company. What happens is that there is a loan after the coinsurance treaty is done. The assuming company loans the assets back to the ceding company, and the ceding company agrees to pay the actual cash flows to the assuming company. Because the cash flows of the treaty are dependent upon this underlying pool of assets, it is a derivative, or there is an embedded derivative that is dependent upon and underlying. Because it net settles, it meets the definition of a derivative for FAS 133.

The distinction that everyone hangs his hat on in saying, "This is a derivative," is the language in FAS 133 that talks about clearly and closely related. The basic risk cash flows are the host contract. The reason you have an embedded derivative is that the risk of the asset cash flows is not clearly and closely related to the host contract. The host contract has credit risk related to the company, so whatever that company's credit rating is is what those cash flows are related to. However, the credit risk of the underlying pool of assets is an amalgamation of the particular bonds and mortgages and whatever else is in there. You cannot say that the credit risk of the underlying portfolio of assets is clearly and closely related to the credit risk of the company. Therefore, because they're not clearly and closely related, it is an embedded derivative.

Here's my editorializing. Like I said, the transition to fair value accounting will be painful, but not all pain is gain. Here are your implementation options. The hypothetical loan is never explicitly described in the treaty documentation. That's why it's called the hypothetical loan. It is the individual fact pattern of each individual treaty that determines exactly what type of a derivative is embedded. I'm sure most of you know there are three basic options: it can be a credit derivative or it can be a total return swap either for a fixed or floating leg. The individual fact patterns, such things as whether the company issues fixed or floating debt, could be one of the determinants that dictate whether or not the hypothetical loan is fixed or floating.

There is no mirror requirement, so if as a ceding company I decide that it's a total return swap with a fixed leg, there's nothing that says the reinsurer has to agree. The reinsurer can't say, "For me, it's just a credit derivative." The exception to that is if you have an internal reinsurance arrangement, and then you're locked in with a mirror requirement. In that case, the right hand must agree with the left hand.

For a credit or total return swap, the accounting treatment of the assets will determine the actual volatility of the earnings for the ceding company. Obviously the assuming company doesn't have the assets. There was a "do-over" provision and a Mulligan, but those have expired. From now on, focus on the future and get them set up correctly going forward.

Here's an implementation option (see Chart 1). I think I cribbed it from E&Y. I did a hypothetical single-premium deferred annuity (SPDA) modco insurance treaty. My assumptions are there. If credit spreads increase 100 basis points, depending on whether you have a credit derivative, a total return fixed or a total return float, if the only thing changing is credit, the embedded derivative behaves similarly, irrespective of what type of derivative you have characterized it as. However, some of the other forms will incorporate other risks; specifically the total return float also incorporates the change in underlying interest rates.

If credit spreads don't move, but the risk-free rate moves, you'll get a tiny movement for both the total return fixed or a simple credit derivative, and you'll get

little change in value of the derivative. If you have a total return float, a change in interest rates will also cause a big swing in the value of your derivative. When you look at that and take that in conjunction with the idea that there is no mirror requirement, it can be difficult to get your mind around how the accounting treatment can be so different. That's the way it is.

Here's a trick that someone from Deloitte & Touche showed me. The way you determine the change in the value of the embedded derivative is you use this simple formula: The derivative is: (the market value of the assets minus the book value of the assets) minus (the market value of the loan minus the book value of the loan).

In the implementation of mechanics, remember that for all fixed risk-free durations, the float is for London Interbank Offered Rate (LIBOR) flat. Theoretically, if you're going to go out in the marketplace and do a swap, if you're trading a fixed risk-free, you're going to get whatever floats, whether it's a 90-day or a daily. You're going to get that flat whatever LIBOR is. If you don't have any credit here, you theoretically should get no spread there. That's what I mean when I say you're going to get something flat.

The book value of the loan is calculated using the swap curve from inception, irrespective of actual principal repayment. If you choose a method where you need to revalue the book value of the loan, you have to save that initial credit, or the initial swap, because that is what you need to use to determine the book value of the loan. That will never change for the duration of the contract.

The one exception is if the modco treaty is a new business treaty and you have new business coming on; you have to save the swap curve theoretically from the day that the new business was put on. The book value of the asset is easy to calculate. The book value of the loan is not terribly difficult, but it does require a model so that you can model the actual principal repayment. There is some diversity of practice out in the industry related to this.

The Academy's life Financial Reporting Committee is preparing a practice note, and the practice note is not an authoritative source of guidance on how you should do it. All it does is discuss variation and practice among the industry. It's not even in draft stage yet. We're still working on getting it to draft stage to expose it, but this is one of the elements that we talked about. Some people feel it should just be premiums and benefits, and some people feel it should be expenses. There is a diversity of practice out there related to the book value of the loan.

If you look at your individual fact pattern and decide that you have a total return swap and are swapping fixed to floating, because the floating rate reprices at least quarterly and hopefully on the last day of the quarter, the market value of the floating rate is always at par. If your loan reprices, it's always at par. The book value of the floating-rate loan always equals par, so these two last terms cancel.

The market value of the loan and the book value of the loan are always equal. Your derivative is the market value of assets minus the book value of assets.

This is probably the easiest implementation option for any direct writing company because at any time it's easy to calculate the value of derivative. It's the change in the capital gains—the realized and unrealized capital gains in your market value of assets because the book value of assets won't change—and it's easy to calculate.

If your individual facts and circumstances dictate that you are swapping floating for fixed, at every valuation period the book value of the assets is going to equal the outstanding statutory reserve. Two different terms cancel, and your derivative is the market value of assets minus the market value of the loan. Again, this isn't terribly difficult to calculate, but it does require that you run some type of an actuarial model and look at the declining balance of the statutory reserve, and that is the pay-down of the principal of the loan. You go back to your swap curve at inception, assuming it's an in-force block, you value that loan repayment using those swap curves and that's your market value of the loan.

For my numerical example, here are my assumptions, if you want to reproduce it at home. If you have fixed for floating, interest rates jump by 100 basis points, credit spreads shrink 22 basis points, your statutory reserve goes down and your book value of assets is \$82.08 plus \$11.07 in cash, then you come out with a derivative of -2.18 that is an asset on your books.

Floating for fixed and statutory reserve has the same change. If interest rates change by 100 basis points, credit spreads shrink 22 basis points and you have the book value of assets, then the derivative is 4.47. I should point out that if your cash flows are perfectly matched, changes in interest rates aren't going to affect you. If you do this floating for fixed, need the market value of the loan, and changes in interest rates affect you, it is the portfolio duration mismatch that creates the change in the derivative. If you were perfectly cash flow matched, you would wind up with -2.18, which was related to credit, and the change in interest rates wouldn't affect you at all.

This \$11.07 in cash is a pseudo-reflection of the cash value of mismatch. If you have too much cash up front and have reinvestment risk, when interest rates moved, that creates a change and you get a much bigger swing in your derivative.

That concludes my portion of the topics, and I will now hand it over.

MS. MATSON: We're going to break the SOP portion into two parts. I'm going to cover the liability for guaranteed benefits, significance of risk testing, and all of that portion of the SOP, and then Carol is going to take over with annuitizations and sales inducements. I know it was mentioned briefly that there has been some new guidance exposed by this panel that has been meeting—a subgroup of the AICPA—and we have some information about what those exposure drafts look like. As I go

through this, I'll cover some of the background and then hit the big issues with which I think a lot of companies are struggling. As I go through those issues, we'll try to hit on some of the new guidance that we've seen and talk a little about that.

Before I start, can I get a show of hands of people who have at least a moderate level of experience with the SOP? Can I get a show of hands of people who have limited-to-no experience? There's enough in that second group that I'm going to try to go through some of the background fairly quickly.

The SOP covers some separate account considerations, which actuaries tend not to get too involved in, so I'm not going to spend much time there. There is a section on valuation of liabilities, which talks about what your accrued account balance should be, because there was some diversity of practice up until now. There's a significance test for insurance contracts, for mortality and for morbidity risk, that helps you classify them as investment or insurance. It talks about how you reserve for guaranteed benefits, including the guaranteed minimum death benefit (GMBD) and the guaranteed minimum income benefit (GMIB), and then it talks about what you do for contracts that have annuitization benefits.

There's also a section on sales inducements, and it obviously talks, as always, about effective date and transition. I'm not going to spend time on how you define the accrued account balance because I don't think there are many contentious issues surrounding this item. If there are questions specifically on this, feel free to raise them when we get to the Q&A.

When determining the significance of risk, all contracts that fall under 97 need to be classified either as insurance or investment. That's typically done at inception, with the exception of when you first apply the SOP. You do that at the time you apply the SOP, and it doesn't change. Once you define them, they stay that way even if the test would give different results down the road.

Basically what you do is look at the present value of your future excess payments. The GMBDs, for example, would be the payments that you have to make in excess of account value in the later years. You compare that to the present value of the future assessments to see if that percentage is more than negligible. If so, you should probably be classifying as an insurance contract. The SOP does say that you need to consider the frequency and severity of the benefits under a range of scenarios. A deterministic approach is not acceptable.

Chart 2 is a graphical presentation. There is a rebuttable presumption that if you have a benefit that has capital markets volatility, you can presume that it has significant risk. You can choose to rebut the presumption and therefore go through the process of doing a significance test. You perform the test, and if it's not significant, it's an investment contract. Also, if the terms of your contract are fixed and guaranteed, that's FAS 60. You wouldn't go any further.

If there's significant risk and the terms are not fixed or guaranteed, it's an unfunded liability (UL)-type contract. To figure out whether you need a reserve under the SOP, you do a test that I've defined as whether or not it's front-loaded profits. The SOP says, "Are there profits followed by losses?" If you have profits followed by losses, you need a reserve.

The SOP excludes anything that you are already valuing under a FAS 133, and here's a list of some of the typical benefits that people are looking at and that the SOP applies to:

VA	GMDB, GMIB, EPB guarantees
VUL	GMDB, no-lapse guarantees
UL	No-lapse guarantees, nonproportional COIs
SPDA	Favorable annuitization options

There are question marks on some of them, for example, the nonproportional costs of insurance (COIs). Generally these are the types of benefits that would fall under the SOP.

The way you'd establish the reserve once you know you need one is you accrue the net portion of your assessments. You figure out what portion of your total assessments you need to exactly cover this benefit on a present-value basis. You do that using what's called a benefit ratio. You then do an accumulation of historical net assessments less historical benefits paid to get your current-day reserve. The SOP says the assumptions need to be consistent with deferred acquisition cost (DAC).

Several issues have come up regarding this topic. The profits-followed-by-losses test says you're going to compare your contract assessments with your contract benefits. The question is, what are the assessments? Suppose I have a UL contract with a no-lapse guarantee. Do I use all my assessments? Do I use my COI charges? Do I use some explicit charge in there related to the no-lapse guarantee? It has been pretty unclear. I think the guidance coming out on this is that you use an explicit charge if you have one, unless some circumstances make it clear that it's not appropriate. If your pricing documentation says, "My expense charges include some charges to cover our shortfall on my COIs," there may be some argument you can make to use other than the explicit charge. If there's no explicit charge, you need to come up with an implicit charge. The guidance helps. It doesn't necessarily make things crystal clear at this point, but it does look as though, in general, explicit charge would be the way to go unless there's some other rationale for doing otherwise.

What benefits do you look at? If you have a COI pattern that's reverse select and ultimate, that in and of itself is generating profits followed by losses, and you also have a no-lapse guarantee, do you have to take each of these by itself and do the

test? Can you combine them? What makes sense? I think looking as though each feature is by itself is going to be the answer. I will say these documents that have been exposed are in a draft form, and people can comment on them. Any of this could change. That could be challenging for someone who's exactly in that situation. It's not easy to separate reverse select and ultimate COI from your no-lapse guarantee when you're trying to do the test.

What level do you aggregate for purposes of calculating this reserve? There are a lot of questions about aggregation. One is, at what level do I do the calculation of the benefit ratio and apply it? At what level do I floor the reserve at zero? The general guidance that's coming out is it should be at the DAC cohort level at the highest. You shouldn't go higher than the DAC cohort level: floor at zero, just at the aggregate company level. Does it make sense? I think DAC cohort level is what's implied. A lower level may be acceptable. From what I've seen, that's what a lot of companies are doing, but for some it will be a change in approach.

Should the SOP apply to normal benefits as in your baseline COIs on your UL? The answer at this point is looking like it might be yes, which I'm sure will not be too well-received by many companies that are hoping for the opposite answer. Do you do all of these tests gross or net of reinsurance? It may be that if you do profits followed by losses on a direct basis, you have a reserve, and if you do it net of reinsurance, you don't. What's the right answer there? I don't think there's any guidance even in draft form on that one.

Another question is, what if I'm already holding an unearned revenue reserve (URR)? If I have reverse select and alternate COIs, and I'm holding a URR for that extra loading the early years, doesn't that address the issue? Am I not done? Initially there was a lot of debate that said this SOP is dealing with that issue instead. URR goes away, and now we have the SOP, so we're all set. Because there has been a FASB Staff Position (FSP) issued and it is still in draft form—it was exposed for comments, and comments have been received—it sounds as though that says that the URR could stay intact depending on "facts and circumstances." Sometimes you would keep your URR, and sometimes you wouldn't. If you do keep it, I think it has to be included in your profit/loss test.

I was on a call last week with a lot of people close to this issue. We went through the FSP, which supposedly clarifies this issue, and there were six different opinions in the room even after reading that. I don't think it's clear that URR is still either okay to keep or needs to be written off. Unfortunately that one is still subject to some debate.

Chart 3 is an example of some of the different ways that the URR can interact with the SOP. This is an example of a UL product. It has COIs that match your expected mortality rates except in the first four years. There's a margin in the COIs in the first four years. You can see happens when you apply the URR. You can see that you're then taking that excess load and amortizing it proportional to estimated

gross profits (EGPs), so that obviously addresses the large earnings that you have in the early years to a fair extent.

If instead of the URR you apply the SOP, what's different is the URR is taking that load and amortizing it proportional to EGPs. What the SOP is doing is taking your excess benefits in the outer years and spreading those proportional to your assessments. They are going at it in a different way. The results in this particular example are not too different. You can see what happens if you have your URR amortization first—you consider that part of your assessments—and you then apply the SOP using that new assessment stream. You can see that one is flat and level. That is not necessarily representative of the level of risk that's coming through on this contract for the insurer. This is one example. I'm sure a lot of product variations would look different on this graph.

Here are more issues. When you calculate the reserve, there has been some debate as to whether the assessments need to be stochastic. It's pretty clear that if you have something like a GMDB, you can't do a deterministic valuation of your benefits or you're probably not going to have any. A stochastic projection is needed for something like the benefits. For the assessments, can you use the deterministic assessments you already had running through your DAC EGPs, or do you need to project those stochastically, as well? They are going to vary somewhat if you use the stochastic projection, and I've seen both used in practice. It's an outstanding question. It's probably something that's worth looking at both ways to get an idea of the impact.

Do you use the mean on the scenarios if you use 1,000 stochastic scenarios? The SOP tells you to use a lot of scenarios, but it doesn't tell you what to do with them once you're done. I don't think I've seen anything other than the mean, but it seems that there could be some argument for using some conditional tail expectation (CTE) measure rather than the mean, or some other alternative. The other question that has come up is, when you have a stream of assessments and a stream of benefits, and you have that information for 250 scenarios, do you then calculate the benefit ratio for every scenario and take the mean of the benefit ratios, or do you calculate the mean of the assessments and the mean of the benefits and use that to get a benefit ratio? Again, that's an area where I've seen both. If you take the mean of the benefit ratios, you're probably going to get a higher reserve because you're matching up a scenario with a lot of benefits with a scenario where there are not as many assessments. It skews the results to be worse.

A lot of companies are facing issues regarding how you go back in time and apply this thing, because as of the day of the implementation for all your in-force contracts, you need to know what all your historical assessments were and all your historical paid claims by cohorts that you're using for the calculation. That's not necessarily available, so that's another practical issue.

Regarding administrative and valuation system capabilities, some of the standard valuation software packages have added stochastic capabilities. Some of them may have 200 stochastic scenarios. That way you could do your SOP reserves calculations right in your valuation system, which makes life a little easier. The only problem is that I've heard some people say, "We can do that, but it's going to take us 64 hours to run 1,000 scenarios through our valuation system," which doesn't get you the numbers you need for your balance sheets in time.

The last question that I think still needs to be addressed is, how do you unlock this thing? The SOP says you need to unlock it when your assumptions are no longer appropriate, when you think those assumptions need to change. This is different from DAC. I think DAC says to unlock it when your EGPs need to change. Here it's focusing on any specific assumption. If you think an assumption is inappropriate, then it may be time to unlock.

We talked a little about the level of aggregation and some of the things that need to be considered when you're talking about aggregation. The one thing I didn't mention is because of the nature of these benefits, if you're using a cell-based approach to do a projection, there's automatically going to be an understatement in the reserve in there because to some extent you're going to be combining policies that are in the money with policies that are not in the money. You have to watch for that and make sure it's not too significantly understating the results that you're getting. I have an example that shows that issue and what needs to be addressed.

One possible approach—and we heard this emerging guidance, but it sounds as though it's fairly consistent with what has come out—is that for purposes of doing your projections, you're probably going to want a fairly granular model because of the understatement issue that I just mentioned. There's a lot of appeal to doing the benefit ratio and the reserves at the DAC cohort level. You don't necessarily have to do that. The nice thing is you then need to run that change of reserve through your EGPs, so it makes it a lot easier if they're on the same basis.

Here's an example of aggregation. It's simple.

	PV	2004	2005	2006	2007
Cohort 1					
AV EOP		45,000	46,000	48,000	42,000
GMDB Benefits	2,381		-	-	3,000
Assessments	7,242		2,600	1,680	3,600
Benefit Ratio	32.88%				
GMDB Reserve		-	923	1,594	-
Cohort 2					
AV EOP		55,000	57,680	59,495	56,036
GMDB Benefits	-		-	-	-
Assessments	4,727		1,720	2,799	485
Benefit Ratio	N/A				
GMDB Reserve		-	-	-	-
Aggregate					
AV EOP		100,000	103,680	107,495	98,036
GMDB Benefits	1,559		-	-	1,964
Assessments	11,526		4,000	4,147	4,300
Benefit Ratio	13.53%				
GMDB Reserve		-	584	1,237	-

We have a return-of-premium GMDB. We have two cohorts, and in both cases we have the account value going up, and then it comes down toward the end of the projection. Because of a difference in the mix of funds between these two cohorts, the extent to which the account value moves is a little different. What happens in cohort one is that your return-of-premium benefit is the \$45,000 that you initially deposited. By 2007 your account values dropped down below the \$45,000, so you're in the money by \$3,000.

In the second cohort, the pattern of movement of your account value is a little different, and you end up out of the money at the end of year three. If you separately calculated the GMDB reserve for each of these two cohorts, you'd take the present value of your GMDB benefits and your present value of your assessments and calculate the benefit ratio. For cohort one, it's 32.88 percent. You then apply that to historical assessments and subtract out benefits to get your reserve. That reserve is \$923 in 2005 and \$1,594 in 2006.

For cohort two, you don't have any benefits, so your reserve is zero. If you combine the two and do the same process as you did for cohort one, you end up with a smaller reserve because in-the-moneyness of cohort one is offset by the out-of-the-moneyness of cohort two. This is something that can happen if you don't pay close attention to how you group policies when you do the calculation.

Let's discuss more issues. What does "full range of scenarios" mean? For something without equity market volatility, you probably don't need to run 1,000 scenarios. A few deterministic scenarios are probably sufficient. Is one sufficient? It probably

depends on the situation. For variable, a general rule-of-thumb that's good to follow is if I did more, would it materially impact my results? If you run 250 and then you run 300, and they have different results, 250 are probably not enough. You probably need to do the stochastic analysis at least once a year. You may need to do it more frequently or use some simplified approach on the corners. The analysts get excited about stochastic stuff. There's some good opportunity in here, and your disclosure is to talk about how sophisticated your stochastic models are and talk about the volatilities. The analysts eat that stuff up.

Regarding the capital market assumptions, they talk about considering historical and future returns, which implies some level of market calibration. It also says that your assumptions need to be consistent with EGPs. For example, if your DAC long-term separate account return assumption is 9 percent, that's probably what you want your mean to be when you're doing a stochastic projection. An issue comes up with mean reversion. If you're using mean reversion for your DAC, does that mean that when you're generating your scenarios, you should use your mean reversion rate over the period for what you're using that for DAC? I've seen some companies do that. I've seen others use the long-term throughout the whole projection period. Both are probably reasonable.

How does this impact DAC? The change in the reserve has to be included in EGPs. There are a few ways you could do that. You could take the full hit over the reserve in the year of adoption. You could go back to each historical period and apply the hit to the EGPs based on the benefit ratio you calculate today. The third option, which I don't think anyone is doing, is that you could go back in time, figure out what your benefit ratio would have been if you calculated it then and take a hit to the EGPs based on that benefit ratio.

The first two are going to give you the same result if you don't have any impact of the zero floor because you're going to accrue the reserve with interest. The accrued hits over time are going to equal your current year hit if you did it all in the current year, assuming that you're including interest on the reserve in your EGPs. You can end up with a situation, depending on how you do this, where there's inconsistency between what's in your SOP model and what's in your DAC model.

For example, if you use static assessments to determine your SOP reserve, if those static assessments in your current valuation system differ from what you've projected in your stochastic model, you can disconnect there, or depending on the way you were reflecting paid benefits in your EGPs before (you may have been using some basis point charge), that's probably not going to equal what you project when you do your stochastic projection. There are a lot of things to be ironed out when you're trying to figure out the DAC impact.

Chart 4 shows the first two methods of reflecting the change in the reserve in the EGPs. The top part of this grid shows your DAC calculations before the SOP reserve. You have a stream of EGPs, you present value those, your deferrals are \$5,000 in

year one, you calculate your case after and then you roll forward your DAC from 2000 to 2004, and your DAC balance is \$3,548.

The second set of numbers shows the calculation of the GMDB reserve. Again, we're present valuing the assessments and the benefits to get the benefit ratio, and then we're rolling forward the reserve. The reserve in 2004 is \$1,283. There are two ways of reflecting that in your EGPs. Using method 1, you take the full hit of the \$1,283 in 2004, so your EGPs were \$1,150. The \$1,283 obviously would put you negative. If you floor that at zero, your new EGPs are zero.

The other way is to go back to each historical year and reduce the EGPs by the change in reserve or the increase in reserve shown in that bottom line of the middle set of numbers. There you don't ever hit this zero floor. The two methods obviously can give you different DAC balances. Method 1 would give you a slightly lower DAC balance in the current year than method 2 would give you.

Regarding treatment of reinsurance, a proposal came out in January that said you should reserve for your net claims plus your reinsurance premiums. To do this calculation, your numerator would include gross claims less reinsurance recoveries plus reinsurance premiums. The idea is that the reinsurance premium is also a cost. The result of that is you are taking your net cost and spreading it out relative to total assessments on the base contract. It produces some reasonable results, depending on how your reinsurance contract is structured. The guidance that recently came out doesn't go against this approach. I think this is still perfectly valid based on the guidance, but there's also discussion in there about potentially amortizing your reinsurance premiums some other way using EGPs or some alternative. This is not a requirement to include the reinsurance premiums as part of your benefit ratio calculation.

Chart 5 is a graph. If you follow this proposed method that was discussed back in January, if you have a reinsurance contract that's 100 percent reinsured, the intuitive thought might be, "My reserve is zero because it's 100 percent reinsured," but under this method, what would happen before is, when you projected out your benefit stochastically, you had your claims based on some assumed mortality and net amount of risk. If you have YRT reinsurance where the reinsurance premiums are based on net amount at risk (NAR), they're probably going to look a lot like your claims, plus maybe some little margin in there for the reinsurer. You're going to have slightly higher costs than you did before, and you can end up with a situation where your net reserve is a little higher than your gross reserve. That's specific to having a YRT treaty, with premiums based on the NAR. It's not necessarily an intuitive result.

The Accounting Standards Executive Committee (AcSEC) Expert Panel met to discuss a lot of these issues, and as we mentioned, they've now exposed some drafts of some papers on those issues for comment. For people interested in this topic, I'd encourage you to track those down and comment as appropriate. The FSP

that came out in the URR issue did say that revisions to the method based on that FSP could be considered a change in accounting principle in second quarter. Our expectation is the same will be true for these new issues. For companies that picked a method for first quarter and now have to change it because of this new guidance, it looks as though that can go through other comprehensive income and be considered a change in accounting principle, which I think is good news for a lot of people.

I'm going to turn it over to Carol to cover the rest of the SOP and the DAC for internal replacements.

MS. CAROL F. SALOMONE: The SOP does address an additional liability if you have annuitization benefits that would be in excess of the account value. Examples of the types of policy provisions that would cause this would be annuity purchase guarantees, GMIBs and that sort of thing—any contract that has the potential benefits that would be payable only upon annuitization, with the exception of anything valued under \$5,133, which is excluded from this SOP. That would be one reason that you would not do this.

An additional liability would be calculated, and this is intuitive, if the expected annuitization payments are greater than the expected account value that would be available in cash at the point of annuitization. The additional liability would be calculated fairly similarly to the method that's used for the insurance benefits. It's a benefit ratio times accumulative assessment with an interest adjustment.

The benefit ratio is going to be calculated a little differently. It's the present value of the expected excess payments divided by the present value of the total expected assessments. These excess payments are equal to the present value of the annuitization payments and expenses based on an expected annuitization rate less the expected account value at the point of annuitization. Unlike the reserve for insurance benefits, there is no significance test here, so theoretically you would need to do this calculation any time that you have these types of benefits. Of course, materiality would always come into account on this.

The SOP points out that the expected annuitization election rate is now one more assumption that you will need to estimate, based either on industry experience or using your own company experience. This additional liability can't come out less than zero when you calculate it. The assumptions that you use in this calculation should be consistent with those that you use in your EGP calculations. Unlocking of this liability is going to be comparable to what you would do for DAC. You need to look at it regularly and update it as it's warranted. The impact of changes to the liability will be reported as a charge or credit to the benefit expenses and will flow through your DAC EGPs.

To summarize, to determine whether you're going to need this additional liability, you look at your contract. The first consideration is whether it's covered by FAS

133. If it is, it won't come under the SOP. It's an embedded derivative and would go to FAS 133. If it's not under FAS 133, you look at the present value of the future annuitization payments that you're going to make and compare that number to the expected account value. If the payments aren't greater than that, you will not need any additional reserve. If they are, you'd go through this calculation process.

Let's move to the next topic covered by the SOP, which is sales inducements. First of all, the SOP does give a definition of what sales inducements are: product features that enhance the investment yield to the contract holder. In a minute we'll go through some examples of these. In the meantime, for something to be counted as a sales inducement, the insurer must be able to demonstrate three things. The first is that these amounts will be incremental to amounts credited on similar contracts that don't have sales inducements. There was a question concerning what a company would do if it didn't have a similar product. I believe it's acceptable to use pricing assumptions and memoranda to make a justification of what a similar contract without a sales inducement would have allowed.

The next criterion is that the amounts have to be higher than a contract's ongoing credited rates for the period beyond the inducement. Finally, they have to be explicitly identified within the contract. If all these criteria are met, we defer an amortized sales inducement consistent with DAC.

Here are some examples of sales inducements: a day-one bonus, which would increase the account value at the point of annuitization; a persistency bonus that would increase your account value at the end of a specified period; and an enhanced crediting rate bonus, such as an interest rate in excess of the current rate credited for a specified period of time.

On the liability side, these sales inducements should be included in the liability for the policyholder benefits over the period, and the policyholder must stay in force to be eligible to receive the inducement, or at the crediting date if that would be earlier. The amounts accrued but not earned need to be included in the account value as they are accrued.

On the asset side, if you meet these criteria, we're told to defer and amortize using the same methodology and assumptions that we use to amortize DAC. That would mean that they would be amortized over the life of the policy.

To summarize, you book it as an asset, but it's not going to be included in your DAC. In addition to DAC you'd have a separate asset, deferred sales inducements, and the amortization of this would be recognized as a component of benefit expense.

I want to point out an example of something that might not be obvious. There's a little inconsistency in the way that the liability and assets would be treated. Let's look at a persistency bonus that's credited at the end of year five. The liability is

going to build up over that five-year period, so when it's credited at the end of the fifth year, you have it in your liability account balance. However, the asset is going to be amortized over the life of the policy consistent with DAC. The liability is going to build up over five years, but the asset is going to be amortized over the entire life of the policy. There will be some mismatching based on the way that we've been told to do this.

As most of you probably know, the effective date of this has already passed. We are all under this. It was effective for fiscal years beginning after December 15, 2003. It's not to be applied retroactively. For instance, sales inducement costs that have previously been incurred would not be adjusted based on this. Report the cumulative effects of this SOP as a change in accounting principles.

We'll talk a little about the DAC for internal replacements. This SOP is still in draft form. It has not been adopted yet, and it has been on the table for literally years. It's moving rather quickly at this point toward adoption. What I'm going to talk to you about now is the form that it's currently in, but I am aware that there have been approximately three changes that FASB has proposed that the committee working on this has agreed to incorporate. I'll have to go through and tell you what the draft form is right now and where there likely will be changes.

The original intent and reason for this SOP was that there was a perceived diversity in accounting practices for how people handled DAC on internal replacements. Primarily the question that this is supposed to answer is, when there has been internal replacement, should DAC be carried over or should it be replaced? Today we'll look at some of the issues that are going to be part of this draft SOP. The first thing they do on this draft SOP is give a definition of what an internal replacement is, and they make it clear that it's any modification in benefit or features, no matter whether it's by amendment or rider, exchange of an existing contract for a new contract or even the election of a benefit internal to an existing contract. They could all meet the definition of an internal replacement. The legal form does not determine the accounting treatment.

Not all internal replacements make the contract substantially changed. They've also given criteria for substantially unchanged, and by definition, anything that does not meet these criteria comes under the category of being substantially changed.

There are several criteria for substantially unchanged. The insured event can't have changed. Basically, the level and type of risk being covered should not have changed for the contract to be considered substantially unchanged. The investment return rights have not been changed between the insurer and the insured. An example is whether credited interest amounts are determined by a formula or the description of the insurer. Those types of decision points cannot be different in the contract for it to be unchanged. No extra premiums should have been required. There should not be a decrease in the account value because of the change. There has been no change in the participation or dividend features. Finally, there has

been no change in the amortization method for DAC revenue classification of the contract. If it meets these criteria, it's unchanged. If it doesn't, by definition it would be substantially changed.

That leads to the question, what is the difference in accounting treatment between the two? Substantially changed is simple. You treat the original contract as having been lapsed or surrendered, you extinguish existing balances and the new contract would set up DAC based on the provisions of the contract as they stand at that day. If it does meet the substantially unchanged provisions or criteria, we're told to treat it as a continuation of the replaced contract, and the treatment is going to differ depending on the original accounting treatment of the product. If it's a FAS 97-type of product, the EGPs would be treated as a revision of the future EGPs of the original contract. It's almost an unlocking concept.

For FAS 91 products, the replacement contract would represent revisions to the future cash flows of the contract. FAS 60 products use what they call a "prospective revision" approach that is similar to what is used for indeterminate premium plans. It's intended to preserve the locked-in concept. The unamortized DAC and benefit liability balances at the point of the change would remain unchanged, and then future changes would reflect revisions to the contract.

Another issue is the internal replacement costs, and this is one of the points that is in contention right now. What I have here is the way the draft SOP is currently written. First of all, you'd go to the accounting treatments to determine exactly the qualification for deferral. For a substantially unchanged contract, the way that the SOP is written right now says to treat it as if it's in the original contract. This is something that is probably going to change, and I'll go into that a little later. For internal replacement assessment, similarly, you need to go back to the original applicable accounting literature to determine the treatment for that. Recoverability is addressed in the SOP. There's no change for FAS 60 products. They still would be subject to premium sufficiency testing.

Another point of contention that I'll talk about in a couple of minutes is the treatment of sales inducements. Another issue addressed in the SOP is disclosures. If the replacement is substantially unchanged, there is a preferred method, but it involves some historical information that may or may not be available, and the SOP does give some discretion about how to handle that. The notes to your financial statements would need to describe the exact accounting policy that you did apply. Transition rules again will be applied prospectively whenever it is adopted without restatement being permitted. Unamortized DAC would not be adjusted to amounts that would have been reported if this SOP had been in place.

My most recent information is that we're expecting this revision to the draft sometime in this upcoming quarter, certainly before the end of the year. Regarding the three items that are under review that were sent back for revisions, my understanding is that the committee has agreed to all of them. There is a change to

those six criteria for "substantially changed." They want additional wording in there that the election of contract features that change it within a fairly narrow range would not be considered substantially changed. There will be a little change modification to that.

Replacement costs incurred should be expensed rather than deferred. That's a 180-degree turnaround from what is in the draft right now. They were not comfortable with the thought of deferring something in a contract after the point when the contract was originally written because there's other guidance that says that it needs to be explicitly stated in the contract, and obviously if it's changed after the fact, it would not be in the original contract.

Similarly, sales inducements should not be accounted for as at inception. The way this SOP is currently written, it seems that it would be at odds with some of the guidance that we just went over from the SOP 03-1 requirement that sales inducements be explicitly identified in the contract. I believe they are going to be making this change.

After these changes are made, it may or may not be re-exposed for comments, depending on whether their opinion is that these changes are substantial enough to require that. At this point I don't know whether they'll make that decision or not. The new target effective date is December 2005. That takes care of this SOP.

MS. MATSON: We have a fair amount of time, so I would encourage questions.

MS. SHARON S. BRODY: I have a question on what you were just talking about, regarding the definition of substantially changed and unchanged and that draft SOP. Does this apply to term policy when it's changing so fast, or is that outside the scope?

MS. SALOMONE: Yes, that type of thing would come under it. You'd have to go through those criteria as they are now, or as they will be revised, to determine that. That's a big issue. My editorial comment would be that I'm not sure this is going to solve a lot of problems or reduce the diversity of practice. There has been a lot of discussion about whether this is going to make things better or worse. You're right. It would affect that type of thing.

FROM THE FLOOR: How about whether the new policy is underwritten or not underwritten?

MS. SALOMONE: That is not addressed in the draft SOP. I would call that additional replacement costs that are addressed in there of what to do with those. As far as whether it means it's a replacement or not, I think the first criterion was the risk itself can't have changed materially, so there's a lot of room for judgments.

MR. DAVID Y. ROGERS: I have a question on the annuitization reserve for the

SOP. One of the things we observed was that different companies were interpreting it a little differently and in some cases were viewing annuitizations allowed under settlement options for traditional life contracts as being either excluded or included into the scope of that provision of the SOP. I was wondering if there was any clarification on that. It seems a lot different to me than what it was originally intended to capture.

MS. SALOMONE: I was going to mention that and didn't. This late-breaking guidance that I referred to explicitly addressed that, and it was clear that a policy does not have to be under FAS 97 to come under this SOP. To my mind that means that yes, the FAS 60-type of settlement option would need this additional reserve.

FROM THE FLOOR: I have a follow-up question to that. You would assume or try to assume what the election rate of those would be. You wouldn't hold a reserve assuming everyone elected.

MS. SALOMONE: No, you're supposed to use your best judgment of what an expected election rate would be. It could well be an immaterial item for a lot of companies.

MR. JOHN W. ROBINSON: Is there any suggestion that there would be any retroactive effect where you might have to go back and change something you did before?

MS. SALOMONE: Everything is prospective.

FROM THE FLOOR: I have a further point. Some people would say that the cost of the settlement option could have theoretically been included in the initial benefit reserve for a FAS 60 contract. You could try making that argument: you thought about it, it wasn't there, you provided for it, and you're not going to reconsider it. I think that argument is harder to make on a 120-type contract than a FAS 60 contract because it's back on the settlement option issue.

MS. SALOMONE: I think you're right, and I think that the formula would probably default to zero if that were the case, because your benefit ratio could well be zero if you don't have excess benefits.

MS. MATSON: I've heard comparable commentary on other types of benefits, where there's an argument that the SOP is double counting, that I hold my account value and my account value already incorporated what I need for this benefit, and so forth. There's some merit to that argument, but I don't think that it's going to be in the long run an allowable argument. It's more of a smoothing. It's addressing the pattern at which some of these things come through your earnings as opposed to whether or not you're holding what we might think of as a true reserve for the benefit. I think that's another issue to consider.

MR. ZIMMERMAN: I would like to add to the comment about the explicit assumption regarding annuitization election rates, particularly with variable annuities. I think it is prudent for the actuary to consider a dynamic formula, because if you have a benefit that can be 50 percent in the money versus 50 percent out of the money, I don't think a level 2 percent is going to cover that range of scenarios. If you have a model that is looking at a stochastic range of interest scenarios, I think it's probably going to require you to develop a dynamic formula that changes your election rate depending on in the moneyness and out of the moneyness.

FROM THE FLOOR: We have a reinsurance GMIB. Do you know what companies are doing or techniques they're using, such as hedging strategies, to reduce or eliminate the volatility on the income side?

MS. MATSON: It seems that a lot of companies are currently looking at hedging strategies to minimize that. At this point none of my clients has gone through and implemented such a strategy, but I know several are looking at it. I would defer to anyone on the panel or anyone in the audience who has additional comments on that.

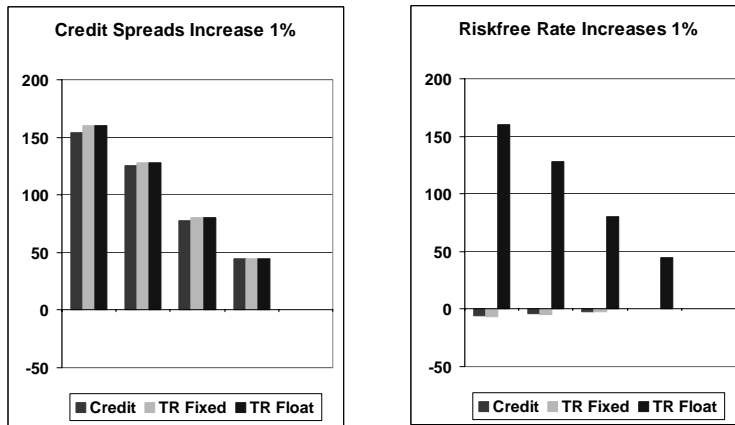
MR. ZIMMERMAN: I know AEGON has a number of hedging programs in place, specifically where we're reinsuring just the equity guarantee on variable annuities. It's a difficult question because you can hedge only one thing. Is it in the shareholders' interest to hedge your accounting results or is it in the shareholders' interest to hedge what you believe are the real economics underlying it? To the extent that the accounting does a good job of explaining the economics, you should be okay. That isn't always the case with this SOP. It's not a good choice, and it's probably going to create some income volatility that isn't real but you're forced to accept in your accounting statements.

Chart 1

Implementation Option Implications

E&Y example of 5-year SPDA 50% mod-co treaty

Credit = 1%; RFR = 5%; Credited rate = 4.5%; 5-year bond available for sale;

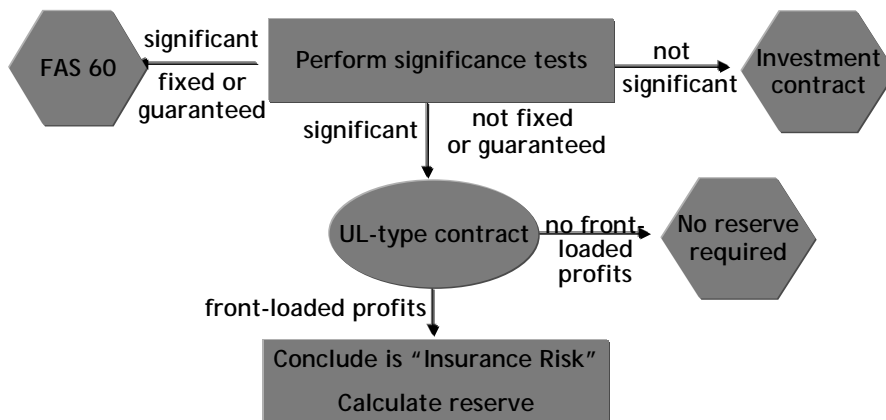


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Chart 2

Significance of Risk

If (a) no capital markets risk or (b) choose to rebut presumption of significant risk, then:

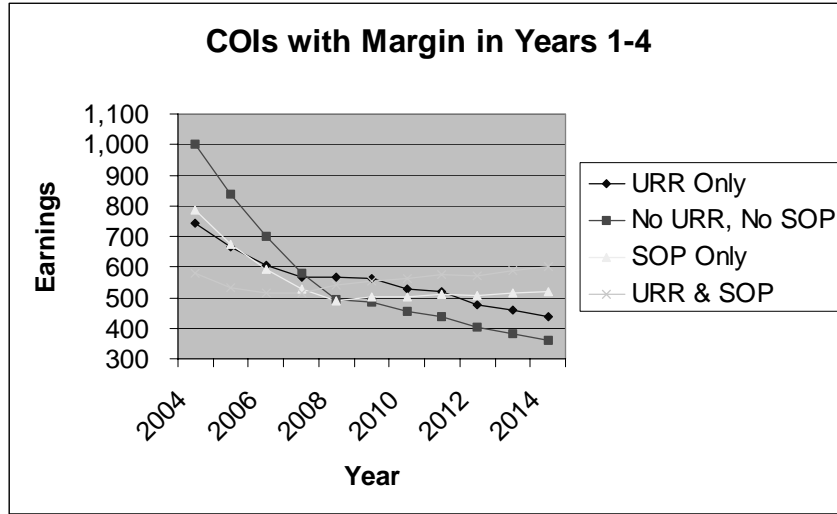


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Chart 3

Reserve for Guar Benefits - Issues

Potential interaction of SOP with URR



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Chart 4

Reserve for Guar Benefits - Issues

DAC impact example - first two methods

DAC	PV	History				Future					
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Account Value EOP		100,000	104,760	109,747	114,971	120,443	126,176	132,182	138,474	145,065	151,971
Deferrals BOP	5,000		5,000	-	-	-	-	-	-	-	-
EGPs	7,400		1,000	1,048	1,097	1,150	1,204	1,262	1,322	1,385	1,451
Amortization Ratio (k)	0.675650479										
DAC Balance EOP		5,000	4,724	4,394	4,005	3,548	3,018	2,407	1,707	908	-
DAC Amortization			676	708	742	777	814	853	893	936	980
GMDB Reserve											
GMDB Benefits	PV 2,712	2,000				525	605	715	802	918	1,000
Assessments	30,747		4,000	4,147	4,300	4,458	4,622	4,792	4,969	5,151	5,341
Benefit Ratio	8.82%										
GMDB Reserve		-	381	807	1,281	1,283	1,221	1,060	817	455	-
Increase in Reserve			381	426	474	2	(62)	(161)	(244)	(362)	(455)
Revised EGPs											
Method 1	0.68833299		1,000	1,048	1,097	-	1,266	1,422	1,566	1,747	1,905
Method 2	0.71294479		619	622	623	1,147	1,266	1,422	1,566	1,747	1,905
Revised DAC Balance											
Method 1		5,000	4,712	4,368	3,961	4,278	3,749	3,070	2,238	1,214	-
Method 2		5,000	4,959	4,912	4,861	4,431	3,883	3,179	2,318	1,258	-

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Chart 5

Reserve for Guar Benefits - Issues

Reinsurance example - AICPA proposed method

