1991 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS

SESSION 10

GAAP/FAS 97/Practice Bulletin 8

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MS. MEREDITH RATAJCZAK: The panelists for our session are Doug Menkes and Cal Jared. Doug is currently a consulting actuary with Milliman and Robertson (M&R) in New York. Over the past 12 years, he has spent a significant amount of his time assisting both life and health insurance providers in their financial reporting, analysis and product development. Prior to joining M&R, he worked for American Bankers in Florida. Doug has served on the Examination Committee for the Society, and he is a frequent speaker at Society functions. Cal Jared is vice president and assistant director of reinsurance operations for ITT Lyndon Life in St. Louis. Prior to joining ITT Lyndon Life, Cal spent several years at the Equitable in New York. Cal also recently served on the AICPA Insurance Companies Committee which was responsible for drafting Practice Bulletin 8. The primary focus of this session is Practice Bulletin 8; however, Doug and Cal will spend some time on items that were not covered in Practice Bulletin 8, such as purchase GAAP (PGAAP) and GAAP for reentry term products.

MR. CALVERT A. JARED II: Meredith indicated that I recently served on the Task Force for Practice Bulletin 8, in actual fact that was back in 1988 and early 1989. The FASB issued FAS 97 in December 1987 with implementation being required no later than the first quarter of 1989. Early on, it was known by a lot of people that there were points of contention or things that needed to be explained, but FASB didn't want to issue a Technical Bulletin because this was such a specialized industry statement. So the AICPA Insurance Companies Committee formed a task force to draft a Practice Bulletin. We started meeting in August 1988, and had a draft very early on, after about six or seven versions. Our goal was to have it published before the end of the first quarter of 1989 so that the guidance that we were going to come up with would be helpful to people prior to their actual restatement. That goal was within reach because in the late fall of 1988, we only had one issue that was really causing a lot of concern and problem, and that was that the committee wanted to allow loss recognition on investment contracts. We wanted it to be permitted or language to say "is not required," but FASB was insistent that its intent was that loss recognition on investment contracts is not permitted. Eventually, everyone acquiesced to get something done, the Accounting Standards Executive Committee

(ACSEC) in January 1989 agreed with everything we had done in the Bulletin. Meanwhile, FASB also took out a number of examples, that we had thought would shed some light on some of the issues, because it didn't think the examples were appropriate. It looked like our goal was going to be met; however, there then ensued a very lengthy debate. After all this process, FASB said, we're not sure that the AICPA should be issuing something that interprets a FASB document, and so the AICPA and FASB debated for almost two years. Finally the Practice Bulletin was dated November 1990 but wasn't issued until January 1991. By then, of course, everybody had gone through at least one year, and were in the process of doing the second year under FAS 97.

So what's the effective date of the Practice Bulletin? The simple answer is it was always effective. What the AICPA was trying to do was issue guidance, and that's important to understand. The Practice Bulletin is not GAAP. The easy way to think of it is as a safe harbor. If you're following what's in the Practice Bulletin, you're okay. If you're deviating from the Practice Bulletin, you should probably revisit what you're doing with your accountants, and conclude whether or not what you're doing is fine and why and, if not, then revise what you've been doing. There was a particular area of controversy in the whole development of this, and that was capital gains which Doug is going to talk about for a minute.

MR. DOUGLAS MENKES: Practice Bulletin 8 ends up being divided into seven categories: acquisition cost, limited payment contracts, internal replacements, the scope of the statement itself, estimated gross profits for universal-life-type contracts, transition, and recoverability of loss recognition on investment contracts. With respect to capital gains and losses, Question No. 11, which deals with this in Practice Bulletin 8, shows up as part of the section on estimated gross profits for universal life contracts, and that's interesting because one might wonder how to interpret what the bulletin says with respect to investment contracts. The question is, "Should gains and losses from sales of investments be included in the amounts expected to be earned from the investment of policyholders' balances used to determine estimated gross profits?" The answer is yes. It goes on to say, "Earned

investment income should be based on expected total yield of the investments. If the timing and amount of realized gains and losses from the sales of investments change from those expected and materially affect the expected total yield and estimated gross profits, the DPAC (Deferred Policy Acquisition Cost) amortization should be reevaluated." Now a quick reading of this that seems to make it clear that capital gains and losses should be included in the gross profits for the year when amortizing the DPAC. But what happens if a company's investment strategy doesn't include realizing capital gains and losses? In other words, the company didn't expect capital gains and losses to be part of investment income. For sure there would be no explicit provision in the estimated gross profit for capital gains and losses when the initial amortization is established. In that case, how do we interpret the statement? I've seen it interpreted two ways. One school of thought is: If none were expected, then any gain or loss is a change from what was expected and could materially affect future estimated gross profits as well as the current year gross profits, and if material, DPAC amortization should be reevaluated. Many companies do it this way. There are some companies, though, that have taken the position that they didn't expect capital gains and losses to begin with, so they are not going to deal with them if they get them, and they don't include them in the actual gross profits for the year when amortizing the DPAC.

What about investment contracts? By including the question on capital gains and losses under the section on universal-life-type contracts, it's not clear from reading Practice Bulletin 8 what the AcSEC intended. I think that the intent was to recognize capital gains and losses if the retrospective deposit method is the method being used to amortize the DPAC, as opposed to the interest method. This would be consistent with the unlocking principle, which is permitted under such method, and I'll talk more about that later on. Now in practice, some companies do exclude capital gains and capital losses from the actual gross profits when amortizing the DPAC for a number of reasons. Again I've touched on one of the rationales (that they didn't anticipate capital gains and losses, therefore, they are just going to ignore them). I've seen other companies take the position that it's conservative to exclude capital losses because to include capital losses in the estimated gross

profits for the year would have effectively slowed down the amortization. And the other reason to exclude is for an investment contract where the interest method is used to amortize the DPAC. It wouldn't be appropriate to reflect capital gains and losses.

Something else has come up over the last couple of years: how to treat the write-down of invested assets. As an example, suppose you have a bunch of junk bonds or some real estate; you don't sell these things but you devalue them. What are you supposed to do? Under GAAP, I believe that when you write down an asset, that's considered a loss even though you haven't sold the asset. Certainly the loss is reflected in your earnings. The amount written down in that case should be charged against the gross profits for the year for amortizing DPAC if it's your company's practice to recognize capital gains and losses, and I've seen some inconsistencies in this area. For example, I'm aware of one company that reflected capital gains and losses for investments that were sold during the year in developing gross profits for the year, but when it wrote down some impaired assets, it didn't reflect those capital losses. To do so would have slowed down the amortization and improved earnings, but it just wasn't done that year. It's clear to me that there are a lot of different things happening in this area. I think that over time, the practices of what companies do with capital gains and losses will come together, but for the time being, there's a wide disparity as to what companies are doing.

MR. JARED: There's also a wide disparity on expenses, I believe. FAS 60, just as a reminder, defined *acquisition expenses* as those that "vary with and are primarily related to the acquisition of new and renewal insurance contracts." We typically all think we know what *maintenance expenses* means. FAS 97 in paragraph 23 said that "costs incurred for contract administration and certain acquisition expenses that are not deferrable listed in paragraph 24 should be included in estimated gross profits." One question that's come up is whether or not you should make an assumption about inflation in maintenance expenses. If so, how much? Is inflation linked to your lapses and earned rate? Another question that's come up is ultimate level commissions and premium taxes, where do those go? The answer is they go in estimated gross profits, but what about flexible premium contracts?

Should you be deferring some of those? The answer, I believe, is that you have to look at each case on its own facts and circumstances and decide what's really happening in the contract. For example, if you have a flexible contract where you have surrender charges that are deposit specific so that each deposit made has its own surrender-charge pattern, you could probably make a good case that the contract really is a series of single-premium-type contracts, and therefore, you ought to be able to defer the commission and premium tax on that. But as I say, each case needs to be looked at on its own.

There are also some questions regarding nondeferrable acquisition expenses and overhead. As we were trying to struggle through the Practice Bulletin, we developed a flow chart. I want to walk you through a couple of things on it. The first question you ask is whether or not the costs are primarily related to acquisition. If the answer is yes, you start branching down and ask whether or not the costs vary with acquisition. If the answer's yes again, then it's an acquisition expense. Now under FAS 60, you would capitalize the expenses and defer them, and there wouldn't be any estimated gross profits. But back up. Do the costs vary with acquisition? Well, if the answer is no, that means that we've got costs that are primarily related to acquisition, but they don't vary with acquisitions, so they must be marketing-type expenses. And those are costs that are expensed as incurred, and they should not be included in estimated gross profits. Why? Because FAS 97 said what is included in estimated gross profits are costs for contract administration, and those things that are in paragraph 24. Marketing expenses obviously don't fall in that category.

If we continue on back in the middle where we had acquisition expense, the next question is, do these acquisition expenses fall into the category in paragraph 24 that said expenses have a "constant relationship to premiums or insurance in force" or (FAS 97 didn't say "or") "are recurring in nature" or "tend to be incurred in level amounts." The best example is ultimate level commissions and premium taxes. If the answer is yes, it means that we have an acquisition expense that falls within that definition in paragraph 24 that they've said is a maintenance-type expense and put it in to estimated gross profits. If the answer was no,

you have an acquisition expense that doesn't fall within paragraph 24; therefore, you capitalize and defer the expenses and you do not include those in estimated gross profits.

Let's go back to the beginning again and take the other branch. If the costs are not primarily related to acquisition, the next question you need to ask is, are they policy-related? If not, then they must be of an overhead type, and again the costs are expensed as incurred, and they're not included in estimated gross profits because they're not in paragraph 24 and they're not for contract administration. If the answer is, yes, they are policy-related, then you go back down to the maintenance expense. Regarding our flow chart, it's pretty easy to understand how we came up with the answers in the Practice Bulletin.

We're going to talk briefly about internal replacements. This was an area where we were convinced early on that FASB probably was just using an example of the traditional life to universal life (UL) type, and really intended to have people write off all deferred acquisition cost (DAC) on internal replacements. FASB assured us that this was not the case, what it meant was exactly what it said, and it did not want to get into the other replacement issues. So FASB's statement was that, on a traditional-type policy moving to a UL-type policy, the DAC on the old policy should be written off and that was all FASB meant to say in the bulletin. It did not want to address anything else. The Practice Bulletin came out that way, and we also stated that, if your accounting policy changed and if it's material, then you're going to have to have some disclosure as a change in accounting principle if you've changed what you're doing with internal replacements. At one point, the SEC staff disagreed with this answer, but it didn't insist on a change, so the issue just went away. Actual practice apparently falls into two groups, those companies that are doing exactly what the Practice Bulletin says, and probably even more companies writing off all the DAC on internal replacements. One of the questions that's come up is on two-tier annuities. When you're in the payout stage, FAS 97 indicates that it is considered a different contract from the accumulation stage, but a number of companies are amortizing

the DAC over the entire life of the contract rather than trying to amortize the DAC over the accumulation period.

I've not heard of anyone whose done any disclosure on unlocking. When we get to the question and answer period, I'd be very interested in having anybody who has done that speak a little bit about it. There could be two or three reasons why there has been no disclosure: Maybe the unlocking wasn't material; maybe companies just thought they were refining their model; maybe it's just too soon to have any big unlocking that would require disclosure. Then again, some companies have apparently said that disclosure really is not required because unlocking is an integral part of GAAP under FAS 97. And so if you've told everyone that you're following FAS 97 and you're on GAAP, implicitly it means that you unlock all the time, and there is no reason to put a red flag for unlocking. My bias would be that appropriate disclosure makes the financials much more helpful to the user, so maybe we can get some discussion about that later on. Now Doug will talk a little bit about unlocking on investment contracts.

MR. MENKES: Practice Bulletin 8 makes a distinction about when to use the retrospective deposit method versus the interest method for amortizing the DPAC. Basically it says that the retrospective deposit method is supposed to be used with an investment contract if the contract has significant surrender charges, or if the contract yields significant revenues from sources other than investment income. For a contract where the primary source of revenue is investment income, the interest method should be used. And again, the interest method is one by which you basically solve for an interest rate that will equate the present value of future benefits and maintenance expenses to the excess of the single premium over the acquisition costs. I've also heard it referred to as a reduction in yield method.

Item 8 in Practice Bulletin 8 goes on to state that, under either method of amortization, the assumptions used should be updated to be consistent with the concepts underlying the method. Now what does that mean? For the retrospective deposit method, I think we all know what it means. The concept of evaluating the estimated gross profits and the

assumptions regularly is something that we've worked with for a few years. Surrender charges or other significant revenues like mortality gains enter into the estimated gross profits and the actual gross profits. For the interest method though, the Practice Bulletin states that the DPAC amortization should be adjusted for changes in the incidence of surrenders, and nothing else. Now I think what this means is that you effectively can change the amortization period as a result of lapses. As an example, let's consider a single premium deferred annuity (SPDA) that doesn't have any surrender charges. For this type of contract, you'd be using the interest method because basically everything you get would come from yield. The initial net reserve would be developed by discounting projected benefit payments and maintenance expenses at an interest rate such that the present value of these cash flows is equal to the single premium less the initial DPAC. Now you're going to make that projection of cash flows based on the rate at which you think you're going to have to pay out benefits. Suppose your lapses are significantly higher in one year. The way I would interpret Practice Bulletin 8 is that you would reproject your future benefit payments and just discount them back, solving for a new break-even interest rate, and that would become your new net GAAP reserve. You have to, or Practice Bulletin 8 would like you to, then basically gross up the net reserve to get a benefit reserve and offset it with a DPAC, but essentially the only adjustment you've made is an adjustment that reflects the fact that you've had heavier surrenders. Under this method, if you were to have capital gains or losses, you wouldn't do anything.

Now let's consider a structured settlement. Many companies that price structured settlements or any very long-durational contracts like these take a fairly conservative posture. They might use a declining interest-rate scale to reflect the fact that they can't lock money up for 30 or 40 years at current rates. Some companies will use a dual interest-rate scale. They'll use a high interest rate or current rate for 15 or 20 years depending on what their investment department can do, and they'll use a lower rate thereafter, a very common and sensible pricing structure. Under the interest method, you're required to use a single interest-rate assumption in solving for the level interest rate, which gives you your initial net GAAP liability. What does this mean? What it means is, if your assumptions

pan out to reflect what you've used in pricing, you're going to have gains in the early years and losses in the later years because a level interest rate is going to be lower than your current rate and higher than the rates you've assumed for later years. Does this make any sense under GAAP? I don't think so, but apparently this is the way that FASB wants it done. You can't make an adjustment in your DPAC for experience deviations, and the gains and losses are going to flow through. Now I'm aware of some companies that basically have ignored this in the past. Either the amount of immediate annuities they write in relation to the total book of business in the company is very small and they say it's just not significant, or they basically say that they are not going to do it that way; they don't think it's right, and they don't want to set a reserve which artificially produces gains in the early years and losses in the later years. And the related issue that goes along with this is recoverability and loss recognition. Practice Bulletin 8 makes a distinction between recoverability, which I think it defines as writing down a DPAC, and loss recognition, which it defines as increasing a benefit reserve for a future contingency. Loss recognition for investment contracts isn't permitted. Again, I'm not sure this won't change down the road but as things stand now, if you have these long-durational contracts, you can conceivably follow the theory of Practice Bulletin 8 and what FASB wants you to do, and set up your liabilities in such a way that you produce gains in the early years and losses in the later years. Now Cal's going to talk about when to unlock future assumptions.

MR. JARED: As indicated, year-end 1991 may be the first time that there's some major unlocking. Most companies have done some unlocking already. It should be pointed out that during the restatement period (the years prior to 1989) most companies did not unlock, which means that they used some degree of hindsight in setting the assumptions rather than trying to go back and pick assumptions that would have been used at the various specific financial statement dates. FAS 97, paragraph 25, is fairly clear. You evaluate regularly how your estimated gross profits are doing. If you need to change them, you change them and do a catch up. When should you do this? Well, the theory says you should be doing it basically every time you issue financials, you at least need to review them. It doesn't mean that you have to unlock or do anything, but you have to at least see if it's appropriate

each time you're doing financials, that's the theory. Of course the big question is, when is something a trend? If you had a blip in death claims for one quarter, well, maybe that's not a trend, maybe that was just a aberration. Then the same thing happens for two quarters, that's probably still just something that will even out over time. You keep telling yourself that for about seven quarters in a row, and you begin to have a couple of problems. One is it may be a long-term trend that's begun to move on you, but just as importantly, you may find that, if you now unlock and change your future assumption on mortality, you've created a big one-time hit (or gain depending on what item you're changing).

For those companies that thought capital gains and losses should be in estimated gross profits, they have been putting their actuals into estimated gross profits, but most have not been projecting capital gains and losses. It will be interesting to see what happens this year-end, though in 1992 maybe we'll have some examples of major unlocking and possibly even disclosure of same. Well, what are people really doing? It appears that most of the people are unlocking annually. A small portion are unlocking quarterly, and then the rest of the people are unlocking seldom. The problem in some of this is that the companies are not really prepared to routinely unlock. They may have a PC-based system, and may have problems in capturing all the data they need to do the evaluation of their experience. In other words, their implementation is not yet complete, they're still getting the kinks out of it.

A totally unrelated topic is reserving for policyholder persistency bonuses. What if the bonus is an interest credit such that a policy that stays on the books for a certain amount of time gets a higher credited rate retroactively? A lot of companies are still using the account balance with the basic interest rate as a base. They can do nothing additional, which means that when you actually pay that additional credited interest, it comes out as a cost when it's actually paid or credited. Some are accruing for the vested amounts. But the preferred method (and what it appears most companies are doing) is accruing the bonuses on those contracts that are expected to persist. That takes into account lapses; it uses the same assumptions as you're using presumably in your DPAC amortization. That

accrual then would be part of estimated gross profits as it's being accrued; therefore, when you actually pay or credit it later, you don't also put it in estimated gross profits. There are also policies where there are persistency bonuses which refund cost of insurance (COI) or expenses. For COI a way to accrue might be as a percentage of COI. Now the key, just as a reminder, is that under FAS 97 what we're dealing with is best estimate with no adverse deviation built in. So again in theory, reserving for policyholder persistency bonuses should be on a best-estimate basis. Where do these things go in the financials? Well, my simplistic view says that, if you're accruing interest that you're going to pay later, then you probably ought to show it as a component of your credited interest in the financials. If you're going to have zero COI in the future, then you probably ought to be building your fund and showing the numbers in the COI, and likewise if you're refunding some expense loads.

Another related issue, which I believe virtually nobody's doing, is realized capital gains that are going to be paid out in the future via an increase in the credited rate. Maybe you did a swap and sold some bonds, and you now have a lower interest rate in the future, but you made that up by these capital gains. As far as I know, nobody's reserving for that.

MR. MENKES: Reentry-term products, one of my pet peeves or favorite subjects, wasn't specifically addressed in Practice Bulletin 8, but there are some interesting concepts relating to unlocking that I want to talk about and see if we can generate some discussion on later. As most of you know, a reentry-term product is one whereby after a certain number of years, you can get a new policy basically at the then current issue-age rate, if you can demonstrate that you're insurable. And if you are not insurable, you pay a much higher attained-age rate. When we think about how to GAAP a policy like this or how to set the reserves, I usually think about a group of people, let's say all the people who are going to buy a particular plan or series in a given year. We know at the outset that ultimately some of those will become what I call reverters; a reverter is somebody who will be able to demonstrate that he can meet the underwriting criteria in order to get the lower issue-age rate, maybe in five or seven years depending on whatever the period is in the plan, and

some of them will become persisters. A persister is somebody who will not be healthy enough to qualify for the lower rates. The problem is that we don't know exactly at the outset how many persisters we have in the group and how many reverters we're going to have, so we have to make an assumption. And once we make that assumption, if we assume that the people who end up being reverters are basically select, we can then solve for the mortality that would have to apply to the persisters. I might add that I haven't run across too many people who have been able to measure or predict reasonably accurately what the percentage of reversions is going to be. These products were fairly new eight or nine years ago, and the first periods after which one could revert are starting to come up now; there's just not a lot of experience in this area.

Now, administratively, companies have had difficulty dealing with how to capture these policies. The simplest way to do it for a reverter is to issue a new policy: treat it as a new issue and use the same GAAP reserve factors that would be used for a new issue. If you do it that way, then you have to make sure that the people who stay on your valuation file as persisters have different mortality rates, because they're all at this point going to be much less healthy than the people who are not there any longer who are given new policies. That is typically the way companies go about the problem. Now what happens when you do that? The real blend of mortality between the persisters and the reverters, if you think of them together, will now reflect the actual number of people who qualified or became reverters and got new policies: while not intentionally, the result is that you basically have unlocked your original blended mortality assumption. Theoretically, you would want each person to have the same mortality assumption, recognizing that some of them would have much better mortality than this average blended rate, and some of them would have much poorer mortality than this average blended rate. But given that this is a mortality assumption and you're not supposed to unlock it unless you have a loss recognition problem, you would be required to do it that way. In practice, I don't know too many companies that are doing it that way. One of the problems you run into is the DPAC. If you are able to set your administrative system to capture the persisters, and the reverters and treat them the same way, then what you may do is end up understating or overstating

your acquisition costs, because your DPAC at that point will reflect what you assumed your percentage of reverters to be when you set the policies up, and you may ultimately have spent different amounts. I don't think that's a particularly good thing to have either. So if time permits when we finish, I'd like to hear something from any of you who have thought about this. It's an interesting problem. It's got some administrative complexities that go along with it, and reentry-term products have been very big for the last few years.

PGAAP is another area that was not addressed by Practice Bulletin 8. I think the general thinking is that FAS 97 does apply to PGAAP. I'm going to talk about some of the things we've seen and done. As most of you probably know, when an insurance company is purchased, the acquiring corporation is required to account for the purchase by restating the assets and the liabilities of the insurance company on a fair-market-value basis as of the acquisition date. That means, for instance, that the bonds, instead of being carried at book value or amortized cost, would be initially put on at their market value. The liabilities should also be revalued, and anytime actuaries are revaluing liabilities, there's some subjectivity. The typical balance sheet, and this is a very simplified PGAAP balance sheet, would list the hard assets as things like bonds, real estate, and stocks; goodwill is an intangible asset, and in many instances, a balancing item. On the liability side, you've got the purchase price and the PGAAP liabilities. The PGAAP liabilities consist primarily of reserves. They would also include items like claim reserves and amounts payable and things like that. Certainly some of the other assets would have receivables, but for purposes of what we're going to do now, let's just think about this very simplistically, so PGAAP liabilities mean reserves. These reserves are going to run off as the business runs off. Goodwill, which is a technical accounting term, is generally amortized on a straight-line basis over 40 years. Therefore, if you can figure out a way to increase your PGAAP liabilities, you're going to increase your goodwill as well because assets and liabilities have to be the same when you start. And if you can do that, you can improve the earnings in the first few years subsequent to the purchase of the company, at the expense, by the way, of later earnings, just because your liabilities run off more quickly than your assets. You

may not want to take this too far because, if anybody sees a very large amount of goodwill associated with a purchase, it may not reflect well on the people who paid for the company.

With traditional business, when we think about how to develop reserves or PGAAP liabilities or PGAAP reserves, there are two methods commonly in use. One is called the defined initial reserve method, and the other is the defined valuation premium method. With the defined initial reserve method the management of the company generally sets goodwill. In that case, the balancing item becomes the initial PGAAP reserves, the initial PGAAP liabilities. Under the defined valuation premium method, management will set the valuation premium for the business it has purchased at a certain percentage of gross premium, suppose 90%, for example. That's another way of saying that management wants to recognize 10% of all future premiums as a profit, and once that is done, the balancing item becomes goodwill.

When FAS 97 came out, it defined some of the terms that we could use both for PGAAP accounting and historic GAAP accounting. Historic GAAP accounting is what we normally think of when we do GAAP, and basically if you think about a UL-type product for a minute, your benefit reserve has to be your policyholder account value, that's just the way it is. The concept of a value of business asset (VOBA) arose, and it is supposed to be the present value of future margins in the policyholder account value. FAS 97 doesn't state this specifically for PGAAP, but it does state it for GAAP in general: margins for experience deviations should not be used. Theoretically then, if you were to apply this concept, you would have no future gains or losses on a block of business acquired. Now most people who buy an insurance company are looking to show gains on the business acquired. In fact, that's one of the games people play with PGAAP. So to take this theoretical result and apply it in practice would discourage a lot of people from buying a company. In practice, many people have started using explicit margins in developing the VOBA. They will either use higher mortality rates, lower spreads, or percentage of premium loads: they'll basically find ways to reduce the VOBA, which is another way of increasing net liabilities so that future gains arise.

The result with this type of business is very similar to what we have with traditional business. The profit comes out to be a percentage of margins (instead of percentage of premiums), plus the difference between experience and actual assumptions, minus the amortization of goodwill. How do you release these margins into profit? No matter how you determine them, and most accounting firms that I've spoken with will allow you to use explicit margins in establishing a PGAAP liability, the margins must be released as a percentage of expected margins. For instance, if you're going to have a percentage of premium load built into your VOBA (in other words you reduce the VOBA let's say for 5% of all future projected UL premiums), you have to bring that margin into earnings in relation to other margins (like mortality margins and investment margins). You could not bring it into earnings as 5% of the premiums you receive. So while companies have used explicit margins, they have been subject to constraints relating to when these margins can be recognized. They have to be released into earnings as a percentage of future margins.

We have a very simple example of a five-year SPDA contract. You ought to think about this as being a small slice of the business in a company. You'll see when we get into the example a little bit further that we're dealing with a liability that runs off in five years, and I'm using goodwill that is amortized over 40 years. In practice, if all the liabilities in your company were going to run off over five years, I don't think your accountants or your auditors would allow you to amortize the goodwill over 40 years, but for a particular block of business, this demonstrates how the game is played. I think some of these terms are fairly obvious. I've assumed for this example, an earned rate of 9.5% and a credited rate of 8%, and the gross profits for the year are the surrender charges, the spread, less the expenses. In case one where there are no first-order margins, I'm going to discount the gross profits at the earned rate of 9.5% and I'm going to get 566. That will be the first example we look at. The second example will be one where I increased the discount rate by 100 basis points, basically I'm introducing a margin, and it lowers the VOBA to 553.

In the first example, again, I'm assuming that the company paid 586 for the book of business. The VOBA was calculated by discounting the present value of the margins at the

assumed earned rate, and the balancing item, goodwill, comes out to be 20. It's interesting to note here that the goodwill is really in this case the premium that the company has paid for the business. It paid 586, the value of the profits is 566, so what it really paid is 20. Let's see how the earnings pan out. The initial VOBA, no matter how you calculate it, is amortized like a DAC in that it's amortized at the credited rate. What I have as margins are really the assumed interest that's going to be earned, and it differs from what I discussed earlier because I've calculated it here as interest earned on the policy account value less the VOBA. We get some funny results when we do it this way, but that's the theoretical asset base of the net GAAP reserve. The benefits are the interest credited, this is basically how we would present the GAAP statement. Expenses are what they are, goodwill is amortized over 40 years so that's 0.5 per year, and we can see the profits that emerge. Future losses are equal to the goodwill of 20, which we would expect. The reason that they don't come out 0.5 per year is that the amortization of the VOBA is artificial in that it's based on 8% instead of the 9.5% earned rate, and the asset base is somewhat artificial in that I've assumed it to be the account value minus the VOBA. But this is a situation where we basically have deferred losses to some extent into the later years. Now let's look at a case where we can do it even more than that.

In case two -- this is the one where we added 100 basis points to the discount rate to come up with the VOBA -- we've effectively raised our liabilities by reducing the VOBA, and the balancing item, of course, is goodwill: Goodwill goes up. Profits during the first five years will be higher, and losses thereafter will be higher as well. Again, the profit over 40 years still is a loss of 20, and it's the real premium that was paid for the business. All we've done is alter the timing by putting some margin into our liabilities: The margins are released over five years; the goodwill is amortized over 40 years. Now in practice, what happens is these losses beginning in year six are going to be absorbed by profits on new business. Again, as I said before, if this were the only business in the company, we wouldn't be allowed to play a game like this, but this illustrates how we've applied FAS 97 to PGAAP. Given the rate at which companies are being bought and sold, I don't see that slowing down a whole lot, I think we're going to continue to see a lot of this in the future. I don't know

whether FASB intends to specifically address the issue of PGAAP, but this is how I've seen it being interpreted in the work we've done.

MR. DANIEL J. KUNESH: I have a couple of questions. There's a proposal to amortize all value of business in force and good will over 14 years for tax purposes. What impact do you think that's going to have on the treatment of taxes on our PGAAP basis?

MR. MENKES: That's a good question. Of course, goodwill's not a taxable item.

MR. KUNESH: I mean right now you bury the effect I guess at the date of acquisition.

MR. MENKES: I don't know the answer to that. I'm not familiar with the proposal either.

MR. KUNESH: Goodwill used to be 40 years, and goodwill on a purchase basis and real goodwill for tax purchases I don't think are going to be that different. They were that different in the past, but you know the value of business in force and the value that you would perhaps use for tax purposes and amortization purposes were generally similar I believe. But now you'll have a significantly different pattern.

I have another question relating back to C-1, C-2, and C-3 risk. We all know that there is a significant amount of default risk, credit-quality risk, etc. To what extent are accounting firms or companies planning on recognizing, say default margins, and establishing interest rates, or is it even permissible? I'm particularly interested in, say structured-settlement annuities and single premium immediate annuities and premium deferred annuities.

MR. MENKES: Well, what we've seen is basically a provision for default as opposed to actual modeling of default in setting up expected gross profits in the future. Many companies will just reduce what they think their gross yields are going to be to allow for defaults. When a default actually occurs, and I talked about this a little bit before, that's basically a loss and it's being treated in a variety of ways right now. If I understand your

question, is it are companies actually trying to model this or how are they handling it? Again, what I've seen is companies saying, well, you know we have a very high-risk portfolio, I'm going to allow 75 basis points or 100 basis points off my current yield in setting up an amortization schedule and establishing expected gross profits in the future.

MR. ALBERT K. CHRISTIANS: I have a couple of questions, one is about the policyholder persistency bonuses. I wonder if you can tell me if we did the right thing or the wrong thing. It seemed like FAS 97 was supposed to set up strict rules for recognition of the very settlements of costs related to a contract, and yet in your presentation of the Practice Bulletin, you mention the accrued amount without giving very much guidance for deciding how much the company should accrue in a particular period. What seemed to me to be a reasonable thing to do with these bonuses would be to either allow them to be an element of gross profits or to exclude them from the gross profits calculation and then amortize them in proportion to the other gross profits that emerge on a contract, which might ultimately result in some of the cost actually being deferred rather than recognizing in advance at the time it was credited. But this process would still give you a concrete, specific method of recognizing the cost and producing a uniform stream of profits without giving the company a lot of leeway for manipulating this concept of "accrual."

MR. JARED: I think in practice, a lot of companies have done both of the things that you're describing. I'll remind you that in FAS 97, it talks about estimated gross profits or account flows, not cash flows. A lot of people have tried to use cash flows because in some instances they are easier to deal with, but again the simple theoretically preferred way would be that you accrue for these items, and you put them in estimated gross profits as if they were actually credited to the account value all along.

MR. CHRISTIANS: But what if there's no basis in the contract for determining how much you would be credited in a given period or what proportion are now earned or something like that? The contract doesn't give you a clear guide as to how much falls in these

periods, it's just an amount that has the account balance at some later year. You'd have a lot of latitude in setting up that schedule.

MR. JARED: It may sound like it, but remember, what you have to do is use your best estimate, and your best estimate of what's going to happen in the future is all of those other assumptions that you've already put into estimated gross profits.

MR. CHRISTIANS: Right. I can make a best estimate of how much is ultimately going to be paid, but that doesn't tell me how much of that cost to recognize in a given period. If you use the estimated gross profit stream as the basis for allocating that cost to periods, that would give you something that FAS 97 seems to rely on as a means of allocating costs.

MR. JARED: And as I say, a lot of companies have done that but a number of other companies built it into the estimated gross profits. The answers you get either way may not be significantly different, and so your accountants may allow you to do either one.

MR. CHRISTIANS: The other thing that's a similar question relates to the recognition of some of the elements of maintenance expense. Companies have discovered that, if you have a UL policy, for example, with no loads on premium payments but pay a level maintenance commission, collecting premium produces a reported loss, and in fact, some companies have done such things as delaying bank drafts for December so that they fall in January instead so they wouldn't have to recognize the loss on collected premiums in a given accounting period. Do you think that FAS 97 really contemplates such a treatment, let's say ignoring the regular rules of accrual accounting to follow this recognition of gross profits on a cash basis like this?

MR. JARED: I didn't follow that real well, but I think the answer is no.

MR. CHRISTIANS: What it means is that you would have to recognize expense on due premiums. Even though they are not due premium items, you might have to accrue some

expenses related to due premiums if for some reason your actual recognition of cash premiums was not timely with the actual periods in which the premiums were due.

MR. JARED: I don't know.

MR. HOWARD L. ROSEN: We've made a couple of acquisitions over the years. I have a question about PGAAP. I realize that there are a lot of people who believe that FAS 97 directly or indirectly addresses PGAAP or vice versa applying FAS 97 to PGAAP. I'm not sure that that's the universal thought, and I would like to pose an alternative type of approach because it seems to me that by applying FAS 97 to PGAAP, you may be developing a fundamental inconsistency in your accounting. That is for a number of reasons not the least of which is the fact that, when an acquirer buys a target company, it's more than likely that the acquirer is not going to be paying at a risk rate of return of 9% for a block of business. It's more likely that the risk rate of return is going to be somewhere between 17 and 22% or 15 and 20% or in that range. If one then amortizes the asset, the VOBA or whatever you want to call it at 8% or 9%, you have a fundamental inconsistency in the matching of the asset that you've acquired and the amortization of that asset.

I think that one can make a very strong argument that there is a fundamental difference in the nature of the VOBA in DAC. The VOBA is in the nature of a monetary asset that is acquired sort of like an inventory, and the DAC asset is the spreading of expense incurred in order to generate a future income stream. Also, it seems to be somewhat inconsistent with APB 16. I think that, if one does PGAAP that way, you're going to have an inconsistency with what little accounting literature there is out there and what your income statements are going to be. Also, I can't tell you how all of the accounting firms feel about it, but it seems a little distressing that a lot of the accounting firms may be blessing margins in the VOBA when APB 16, FAS 97 and everything else relating to GAAP basically says that for intrasensitive products, you have no margins for deviation, and APB 16 says that you capitalize the fair value of the assets acquired. So if you're allowing a

margin to flow through, you're basically inconsistent with all of the accounting literature that's out there. I don't know if anybody has any comments on that.

MR. CHARLES D. FRIEDSTAT: I wanted to make one comment in relation to PGAAP that may relate to what Howard said. We did a survey on FAS 97 revisited, and one of the questions related to PGAAP. Also based on experience in talking with people, we find a lot of people when determining the initial VOBA, have not changed and would have done the same approach as they would have prior to FAS 97 that would involve discounting the future profits at a risk rate of return. So in determining the initial VOBA, there may not be, and I don't think that FAS 97 addresses this, any reason to have anything other than a discounted future profit risk rate of return. There are certain implications in that. Profits will emerge other than zero if actual experience emerges. It'll conform a lot closer to your appraisal value. Where there seems to be a difference in practice is how you amortize the initial VOBA, and maybe that's what Howard was talking about. A strict application of FAS 97 would say that you should amortize VOBA based on a credited rate that would result in a very unusual pattern of earnings, different than you anticipated in your appraisal. If you do amortize VOBA based on your same risk rate of return, you'll have a relatively predictable expected future profit if things emerge as expected, and there will be advantages to that, but I think that's really the distinction. A strict application of FAS 97 would lead to an unusual pattern of earnings.

MR. MENKES: Like my example probably.

MR. FRIEDSTAT: Yes, yes, but the main difference with your example that we see in fairly common practice is that people are getting that initial VOBA by discounting future profits at a risk rate of return.

MR. MENKES: That's right.

FROM THE FLOOR: If I could just respond for one second. I absolutely agree and if one buys an asset to yield 19% and one's assumptions are right on, why shouldn't that asset yield 19%? I think if you apply FAS 97, there's not a chance in the world that that's going to happen.

MR. MENKES: I agree. Cal, was PGAAP one of the topics that was submitted when all the questions were sent in for Practice Bulletin 8? I know there were a lot more questions sent in then ultimately were answered.

MR. JARED: During our first meeting, we probably had three or four times as many questions as ultimately made it into the Practice Bulletin. One of them was on PGAAP, and quite frankly, what I do remember about why it didn't make it in there goes something like this. It was clear to everybody that FAS 97 did apply to PGAAP and that FASB would support that. And so it didn't make sense to have a simple question in the Practice Bulletin that said does it apply because then the next thing would be, well, how does it apply? That subject by itself would have dwarfed all the other items that were in the Practice Bulletin, and the Insurance Companies Committee didn't want to deal with that. So early on, the committee said, let's not talk about PGAAP.

FROM THE FLOOR: PGAAP has been an issue going around. I found it very interesting if you go back to all the history of PGAAP, you talked about some of the guidelines that were to be used. But going back to the early 1980s, there was a subcommittee of the AICPA Insurance Companies Committee that was going to be dealing with PGAAP. That subcommittee had a lot of interesting theory on PGAAP and its members were moving in certain directions. They talked about a return on investment approach. At the last meeting about six or seven years ago, they came to one final conclusion that they were not going to meet again, and that was really the only decision that they actually came to. There was no final pronouncement that came out in terms of any position paper on PGAAP. But there was a lot of good thought done that supported a return on investment sort of approach that we've been talking about and some of the things that Howard was mentioning. But there

really is not a lot of hard documentation on PGAAP for a life insurance company other than in the early days that defined a valuation premium and defined initial reserve method. Certainly when we go into intrasensitive products that involved acquisitions, it's very common to have some sort of a return on investment approach. But there's not a lot of hard guidance out there, and certainly I think one of the reasons why FAS 97 didn't address PGAAP specifically is FASB had no base guidelines in which to tie PGAAP into.

MR. JOSEPH H. TAN: I have three questions/comments. Since it's a favorite topic, let me put in my words for PGAAP also. I agree with the discussions so far about discount rate at the risk rate of return, but I think the theory is correct to the extent that you don't want any gains or loss to emerge, that you have to use the risk rate of return. However, let's just focus on an example. Let's say the only block of business you have is a purchase block. By discounting at the risk rate of return, will you run into a recoverability problem of the VOBA? In other words, what you earn is the earned rate, but you're assuming that you're going to get the higher risk rate of return. I know recoverability is not an issue, and that normally is not a problem since companies will tend to merge the VOBA with other blocks of business. That's just one point to keep in mind.

My second question is I have a difficulty understanding the difference between a persistency bonus and surrender charges. It seems to me that both of them accomplish the same result. It's just one is stated in a more positive manner, the other is in a negative manner. I think all of us agree that FAS 97 is pretty clear on how surrender charge ought to be treated both in the reserve and estimated gross profits. The question is how come we think that we can treat the persistency bonus in a different manner?

The third question relates to the tax issue. GAAP has always been done more on the pretax basis in all these estimated gross profits and recoverability tests and so on. With the new DAC tax, I wonder whether it's appropriate to include that in the estimated gross profits.

MR. MENKES: Let me talk a little bit about recoverability. I'm not sure I follow your argument. It seemed to me if you're going to discount your future profits at a higher risk rate of return, you'll lower your VOBA thereby raising your liabilities, making the prospect of recoverability problem less likely. Of course if you're dealing with an investment contract and using the interest method, recoverability's not an issue because you can't have it by definition. But did I understand your question correctly?

MR. TAN: I guess my question relates to the amortization, not so much on the setting up of initial amount. Like in your example, you illustrate that you amortize it on a different rate.

MR. MENKES: I could see how that can happen. The persistency bonus comment is interesting. I know that some state insurance departments consider persistency bonuses to be surrender charges. If you try to come out with an annuity contract in a state that has a maximum surrender charge of let's say 7% and you've got dual interest rates or persistency bonuses or things like that, the state actually makes you count the lost bonus basically as a surrender charge and add it to any explicit surrender charges to see whether or not the contract complies. So you raise a good issue there.

MR. JARED: I'll just read the first sentence or two of paragraph 20 of FAS 97: "Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue." This goes on and on and on. In regard to the example that I gave on COI where you have a COI charge in the first 15 years, and then in the next five years you don't have one, it seems to me you could be making a case that says that you probably overcharged in the first 15 years and you're certainly undercharging in the next five, so why not set up an unearned revenue on that? In my mind, I view all of the persistency bonuses in the same way. They may be displayed differently and in different places in the financials, but I don't really see any difference between whether a persistency bonus is return of COI,

some COI charges, expense loads, or whether it's extra interest, and I think you need to accrue.

MR. VINCENT P. GALLAGHER: We're not doing GAAP right now, but there was a time not too long ago that I was interested in recoverability under FAS 97, and as I understand FAS 97, you're setting your expected gross profits on best estimate assumptions so presumably you would use the same assumptions for recoverability testing. And what this causes is that, if you make your assumptions more aggressive, you would not only increase your level of DPAC, your unamortized expense, but also you would broaden your recoverability margin. And just the opposite would happen if you become more conservative: you would lower your DPAC, yet it would be less recoverable. This makes no sense to me. Have there been discussions about this?

MR. MENKES: Pat, are you talking about the rate of amortization here?

MR. GALLAGHER: No, I'm talking about assumptions on future gross profits, future investment spreads, for instance.

MR. MENKES: Well, I try not to make a distinction between writing down a DAC and setting up a liability. I tend to think of it more in terms of a gross premium valuation, and doing one based on my best estimate and comparing it to my net GAAP liabilities, no matter how I got them. Under that type of a scenario, I think that, if I'm going to be more aggressive in terms of what I think future profits are going to be, certainly my results will look better because my required reserve, my gross premium reserves, are going to be lower.

MR. GALLAGHER: But you're using the same assumptions to actually set the level of your GAAP reserve. Under FAS 60, you have margins in your calculation of DPAC or net liability, whatever you want to call it, you would then show recoverability without those margins, so you're not making the same assumption in both cases. In FAS 97, you seem to do the same thing, so as you become more aggressive in your assumptions, you not only

lower your liability, but also you become more recoverable. If you become more conservative, your liability goes up, but you have trouble showing that you can sustain that.

MR. JARED: The automatic unlocking though is the thing that helps stop that. If you were too aggressive, at some point it's going to show up in that amortization.

MR. GALLAGHER: Oh, at some point it will. I'm not talking about what's actually going to happen now. I'm talking about where I am today.

MR. MENKES: I understand. Just like if you take a capital loss and use it against actual gross profits, you're going to slow down your amortization. I agree.

MR. DAVID L. OLMSTED: I'd like to make a comment. You can imagine two situations. In one case you've got the actuary choosing between a 100 and 150 basis-point spread, and the assets are mostly out in the future so the spread gets the effects you're talking about. The other situation is you could have two companies: one actually knows pretty well that it's going to experience 100, and the other one 150. The one that really can get 150 obviously will have a slower amortization of DPAC, and obviously it will be easier for that company to recover the DPAC. Now that situation is real and produces the right result, and there's no way to distinguish it in the calculations from the situation of the actuary choosing between a less and a more aggressive assumption. So I think you're stuck with the result you're talking about even though in the one situation, it's the right one. The other one, it feels a little funny but really the actuary is choosing which situation he thinks he's in.

FROM THE FLOOR: I just wanted to add one comment to this. When you talk about recoverability, don't fall into the trap that you just look at your DPAC number. The gross premium valuation would be done at an earned rate generally, and of course, you're amortizing your asset according to FAS 97 at the credited rate. So there are some differences in terms of your potential loss recognition review. I had another comment in

relation to what Joe Tan said, and I think this is something that we should be aware of. Let's take a situation, where because of the DAC tax, we've decided to recover part of it via increased margins. Presumably, we'll unlock because our future assumptions will change, maybe we'll recover the tax from an interest margin. Our whole pattern of estimated gross profits is going to be different. When we go back and unlock, we're probably going to wind up amortizing less because of this change, but the point is, we're not reflecting any increased tax in that early year in our tax provision on GAAP. That's the way a strict application of the rules are going to apply. You're going to have less amortization, but you're not going to have a matching of the tax expense related to that until a future period, and that's probably something people should be aware of. That's the way the rules have it. You're not allowed to make that tax expense level to produce what you might think would be the same result. So a company that in essence had a profitable product at a certain return on investment before and decided it wanted to keep that same return on investment over the life of the product and upped its gross profits this year will probably have a greater return on investment in the early years on this product because of the way the GAAP does not match the tax expense with the pretax income. It's going to be a very unusual pattern of earnings. And if you're trying to explain some results if you made some changes in your margins in relation to the DAC tax, you might want to be aware of that.

MR. MENKES: That's a good point. GAAP tax has never made a whole lot of sense.

FROM THE FLOOR: I just wanted to follow up on a little of the earlier discussion and take it one step further. I'm wondering if Cal or Doug or anybody in the audience is aware of whether or not the FASB considered the following situation. Suppose you sell a FAS 97 product that has very thin margins. In fact, it has no margins at all such that your DAC is exactly equal to the present value on some basis of your amortizable expenses. When you set up your FAS 97 asset, you're taking the present value of expenses over the present value of gross premiums discounted at the credited rate. Now FAS 97 says, when you're looking at recoverability, you follow the tenets of FAS 60. So when you take your present

value of a variable revenue, you discount that stream not at the credited rate but at the earned rate. Under the scenario that I just mentioned, you have a built-in loss.

MR. MENKES: That's right.

FROM THE FLOOR: How do you deal with that?

MR. MENKES: You take down some of your DAC. I mean you're talking about a product basically where your expense premiums are 100% of your margins, right?

FROM THE FLOOR: You've got a break-even product. You're selling the product because your agency force wants it, because it gets you in the door somewhere else, and if for no other reason, because it absorbs overhead and makes the rest of your business profitable.

MR. JARED: But it was break-even on using what interest rate?

FROM THE FLOOR: I'm following the accounting literature. The accounting literature says that, when I come up with my DAC asset or my amortization of my DAC asset, I come up with the present value of deferrable expenses that in all likelihood are going to go over a period longer than the first second after I sell the product, perhaps two, three, five, 10 years. I discount that stream as well as my estimated gross profits stream at the credited rate. Now I continue reading FAS 97 because I'm a good actuary and I want to follow all the accounting literature along with all the actuarial literature, and it basically says, when you look at recoverability of DAC, you refer back to FAS 60. FAS 60 either directly states or implies, I forget which, that when you're calculating the present value of available revenue with which to amortize your DAC asset, you use the yield rate, your best estimate of what you're going to earn on your assets. If for argument's sake there's 100 basis-point spread between my credited rate and my yield rate, at day one I've got a loss recognition problem because I'm following the literature.

MR. JARED: That's right.

FROM THE FLOOR: Doesn't that sound somewhat inconsistent?

MR. JARED: But I think the actuaries all agreed that using the crediting rate makes no sense anyway, but that's the rules.

MR. CHRISTIANS: I've got a comment on the same problem. In fact, because of the interest on interest calculation, virtually every UL product sold gets into this situation if you check recoverability close to the maturity date. The basis and method that's specified in FAS 97 will lead you straight into recovery. The only problem is the interest element comes to dominate, and you have disparate interest rates. However, the alternative is pretty grim in terms of theory as well because, if you were to instead determine recoverability on the credited rate, you can pay over 100% commission on a single premium product and not have a recoverability problem, so it seems we're stuck with one inconsistency or the other.

MR. MENKES: I think as long as all of your business isn't about to mature and you have margins in other products, these types of things are going to fall through the cracks. Even with the traditional GAAP accounting, you've always had products where your GAAP premium is more than 100% of gross. You typically don't strengthen three or four sells, maybe you have an age where you're losing money. Those just fall in with all the other products, and if on balance you don't have a recoverability problem, most people don't worry about it. I think that's what's going to happen here because there's always going to be certain situations where what we're forced to do for GAAP just doesn't make any sense.

MR. KUNESH: Howard, I asked the very same question of Wayne Upton, project manager of the FASB, just before FAS 97 came out, and he indicated that there are a number of inconsistencies between 60 and 97 quite obviously, and where there's a trade back that the intent of FAS 97 would rule here. In other words simply because you're discounting under a recoverability test at the earned rate would not preclude having your right to continue

that DAC if under FAS 97 those were the rules. The intent of FAS 97 was to amortize in relationship to a credited rate. That is the rule and that would dictate the write-off on the recoverability test.