1990 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS

FAS 97: INVESTMENT CONTRACT ISSUES

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Level Interest Rates for Certain-Only Contracts

Annuity contracts with a substantial certain period, such as 20 years, would likely be considered investment contracts since FAS 97 was adopted. This issue deals with the interest assumption for GAAP reserves and deferred acquisition cost amortization. Does FAS 97 require projected interest rates to be level, or are graded rates allowable?

FAS 97 states that investment contracts should be accounted for "in a manner consistent with the accounting for interest bearing or other financial instruments." FAS 97 does not offer specific instruction on how to comply.

One method in common practice to account for investment products is the interest method, the objective of which is to produce a constant effective yield, including any fees and costs.

The issue is whether the interest method requires companies to use a level interest assumption to calculate benefit reserves and DAC amortization on investment products to achieve the constant effective yields. If a graded assumption is to be used, what, if any, is an appropriate margin for adverse deviation for investment products? Would an actuary's "best estimate" of interest assumptions likely result in a graded interest assumption on these

products? What assumption is most consistent with the lifetime of the assets backing investment products?

What is an Investment Contract?

FAS 97 defines investment contracts as policies "that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity." These contracts are to be accounted for as "interest-bearing or other financial instruments."

Obvious examples of contracts that might be considered investment contracts under FAS 97 are:

- Guaranteed investment contracts (GICs)
- Immediate annuities without life contingencies
- Deferred annuities in the accumulation phase

If significant insurance risk is present, a contract should be classified as either universal life or limited pay, depending upon guarantees. One issue is what level of insurance risks is significant? Another consideration is related to contracts that do not have significant insurance risks at time of issue but will have significant insurance risks if the policy survives long enough. An example may be a life annuity with a 20-year certain period. Should a

policy of this type initially be classified as an investment product, then be reclassified as an insurance product when the mortality risk passes some threshold level?

Are companies applying an overall test of materiality to the annuity line?

WHAT ARE REASONABLE ASSUMPTIONS FOR NEW PRODUCTS?
HOW MUCH MARGIN FOR ADVERSE DEVIATION IS ALLOWED OR REQUIRED?

John Glass

Under FAS 97, estimates are made for each element of estimated gross profit, "each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation."

The four main elements of estimated gross profit are:

1. Gain from mortality
2. Gain from interest
3. Gain from terminations
4. Gain from expenses

Reasonable assumptions for new products under FAS 97 are therefore to be realistic assumptions, without the specific margins for adverse deviation previously utilized under FAS 60.

Assuming pricing assumptions are realistic, there is no reason that GAAP assumptions at issue cannot be the same. Otherwise, actuarial judgment may be called for in order to achieve the use of realistic assumptions for GAAP.

As the book of business ages, historical experience develops. This is utilized to "true up" assumptions retrospectively as well as to develop revised assumptions for the future under the "unlocking" process.

Where new products differ significantly from prior products, or where future experience is expected to differ significantly from past experience, common sense indicates the utilization of available significant data tempered with actuarial judgment, particularly as to the company's latitude and ability to manage profitability on an after market basis.

The amortization of the DAC asset is directly impacted by the incidence of gross profits over time. The use of realistic assumptions initially and within the unlocking process will foster the emergence of quality earnings to the extent permitted by the FAS 97 accounting model. The use of unrealistic assumptions, which distort total estimated gross profits, or the incidence thereof, can cause unfortunate sizable adjustments to current earnings during unlocking. Such adjustments may cast doubt on any sense that the GAAP accounting is tracking the economics of the enterprise, which is GAAP accounting's reason for being.

EFFECT OF THE APPLICABLE FEDERAL RATE

George J. Hebel, Jr.

The Revenue Act of 1987 amended Section 807(d) of the Internal Revenue Code. Prior to this amendment, the interest rate used for calculating tax reserves was the "prevailing state assumed rate," that is, the highest rate allowed by at least 26 states. As now amended, the interest rate used to calculate tax reserves for 1988 and later issues will be the greater of (1) the prevailing state assumed interest rate at the beginning of the calendar year in which the contract is issued, or (2) the applicable federal interest rate (AFR) for the calendar year in which a contract is issued.

The AFR is the annual rate determined by the Secretary of the Treasury under Section 846(c)(2) for discounting loss reserves of property and casualty insurance companies. The AFR is calculated as the rate equal to the average of the applicable federal midterm rates effective as of the beginning of each of the most recent 60 calendar-month period ending before the beginning of the year in which the contract is issued.

The Revenue Act of 1987 provides life insurers a one-time election to have the AFR recomputed every five years. Under the election, the rate applicable in the year of issue applies for the first five tax years of a contract. For years six through ten, the rate is the greater of the AFR in year six or the prevailing state assumed rate in the year of issue. In

year 11 and every fifth year thereafter, the process is repeated. However, no change is made to the interest rate used to calculate reserves if the updated AFR is less than one-half percent different from the rate used by the company in calculating reserves for the prior five years.

The special one-time election applies to all contracts issued during the calendar year for which the election was made or during any subsequent year unless such election is revoked with the consent of the Secretary of the Treasury.

The Revenue Act of 1987 has caused many companies to update valuation systems to handle the annual redetermination of appropriate tax reserve factors for business currently being issued. Companies considering the special one-time election with regard to reserve calculations would probably have developed projections of future AFRs under varying scenarios to determine the impact of the election.

With the enactment of the Revenue Act of 1987, companies are generally faced with a prepayment of federal income taxes. It is appropriate for the valuation actuary to consider this inherent prepayment as an added margin when considering whether the reserves "make good and sufficient provision." Is it possible that the prepayment of taxes, as taxable

income exceeds statutory income, could indicate intermediate term insolvency within the context of long-term solvency?

ALTERNATIVE MINIMUM TAX

George J. Hebel, Jr.

The Tax Reform Act of 1986 imposed an alternative minimum tax (AMT) on all taxpayers, with the goal of taxing corporations that consistently report significant earnings to the public but pay minimal federal income tax. Because of the basis used to develop the AMT for tax years 1987-89, the calculation of the AMT has not yet been a problem for most life insurance companies. However, several important changes in the formula for calculating life insurance company AMT are effective for tax years beginning in 1990.

The principal changes in the calculation of AMT are the adjustments for tax preference items, such as elimination of the deduction for small companies allowed under Section 806 and the inclusion of the annual increase in deferred acquisition costs (DACs) in computing alternative minimum taxable income. The capitalization and amortization of acquisition expenses applies to new and in-force business. When considered in conjunction with the use of tax basis Commissioners Reserve Valuation Method reserves, (which implicitly reflect some deferral of acquisition costs), the AMT DAC represents some double deferral. This "overlap" is an obvious anomaly, and was the subject of comment in the Committee Reports to the Omnibus Reconciliation Act of 1989. In May 1990, the IRS issued Proposed Regulation 1.56(g)-1, which not only addressed certain aspects of AMT calculations, but also invited taxpayer comment on several remaining issues.

Management is presented with a new "balancing act" to perform since the new AMT requirements create a conflict between maximizing reported GAAP earnings and minimizing taxes. Company managements must find this balance within the bounds of the range of GAAP methods and assumptions acceptable to their auditors and IRS examiners.

Some companies that already develop GAAP results, may choose to use their GAAP DAC for tax purposes. However, it will probably be necessary to calculate the deferred acquisition costs that are implicit in tax reserves, if clarifying regulations from the IRS follow the comments in the Committee Reports.

For companies that don't publish GAAP results (most mutuals and many small stocks), the DAC calculations will be new. Even companies that don't expect to be in an AMT position will have to do the calculations.

Significant issues and questions related to AMT DAC calculations remain open, such as:

- What is GAAP for pre-1973 issued in-force business?
- What constitutes GAAP for mutual companies?
- Will there be relief from the DAC "overlap?"
- Are GAAP recoverability and loss recognition principles to be applied to AMT DAC?

- Must the methods used for AMT DAC be consistent with the methods reflected in GAAP financial statements?
- How does the DAC coordinate with capitalized ceding commissions under Colonial American and value of insurance acquired under Section 334 or 338 liquidations?
- What is the appropriate amortization method for universal life policies issued prior to the publication of FAS 97?

AMT may effectively be a timing difference which can be offset against future regular taxes. It is appropriate for the valuation actuary to consider this inherent prepayment as an added margin when considering whether the reserves ... "make a good and sufficient provision."

NOTE: The "budget summit" agreement of September 30, 1990 contained language which suggests the AMT DAC provision in the current law be repealed effective for taxable years beginning after September 29, 1990.