

**1995 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS**

SESSION 11

GAAP Issues/Fair Value Reporting

J. Peter Duran

George E. Silos

James D. Wallace

GAAP ISSUES/FAIR VALUE REPORTING

MR. J. PETER DURAN: I'm with Ernst & Young in New York. We have two panelists. George Silos is an actuary in New York Life's financial management department. His responsibilities include asset/liability modeling and management. He has assisted the working group on liabilities of the American Council of Life Insurance (ACLI) Task Force on Market Value Accounting with modeling alternative accounting methodologies. George was a 1991 through 1993 vice president for student education for the Actuarial Society of Greater New York. He's going to talk to us about various approaches to determining fair value of liabilities.

George is going to be followed by Jim Wallace. Jim is an FSA and a Certified Public Accountant (CPA). He's a partner in Ernst & Young's Des Moines office and is responsible for its services to the insurance industry for the eastern part of the U.S. Jim is a member of the Academy Committee on Life Insurance Financial Reporting. Jim will speak to us about *Financial Accounting Standard (FAS) 115* and other GAAP-related matters.

MR. GEORGE E. SILOS: I will speak on fair value accounting for financial liabilities. I work in New York Life's individual operations financial management department, where my responsibilities include asset/liability modeling. For the past two years, I have assisted the working group on liabilities of the ACLI Task Force on Market Value Accounting with modeling alternative market value of liability accounting methodologies. The working group was formally disbanded on September 8, 1995. My presentation does not represent the views and opinions of New York Life or the ACLI.

I hope to provide you with information to help you form an opinion as to the need for fair value accounting for financial liabilities. Good arguments both for and against such fair value accounting can be made. I also will illustrate how contributions to GAAP equity might emerge under a fair value accounting for financial liabilities. I plan to touch on the discussion of marking liabilities to market,

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included in Appendix A, paragraphs 49 through 56, of *FAS 115*; the impact of *FAS 115* on financial analysts; and the initial industry response to *FAS 115*.

I will also discuss how the current GAAP framework might impact any possible fair value accounting methodology, and then give a brief overview of some of these methods, including examples of how some of these methods would impact GAAP equity and the contribution to GAAP equity. I will discuss the idea that the value of a financial instrument depends on who is doing the valuing. I will wrap up with a discussion of possible interest rates and spreads to use in discounting liability cash flows, and on how accounting research may help to frame the debate about a possible fair value accounting for financial liability standard.

When the Financial Accounting Standards Board (FASB) issued *FAS 115*, it did not ignore the fact that the standard was one-sided and that it marked some assets to market without marking liabilities to market. *FAS 115* is not entirely asset oriented. In fact, paragraphs 49 through 56 of the standard specifically address financial liabilities. Paragraph 49 of *FAS 115* notes that "some ... financial institutions manage their interest rate risk by coordinating their holdings of financial assets and financial liabilities ... suggests that, in order for financial statements to present a more accurate view of an enterprise is exposure to risk, some liabilities should be reported at fair value if some investments are required to be reported at fair value."

In paragraph 56, FASB notes that it "would be preferable to permit certain related liabilities to be reported at fair value if *all* investments in debt securities were required to be reported at fair value." However, all securities are not required to be held at fair value, e.g., commercial real estate loans, policy loans, and held-to-maturity debt securities.

Paragraph 51 of the standard notes that no proposals to permit certain related liabilities to be held at fair value were "workable and not unacceptably complex or permissive." Also, the paragraph notes that difficulties arose in trying to identify which liabilities should be considered related to the debt securities being reported at fair value.

In paragraph 53 of *FAS 115*, FASB also noted that there was no consensus as to whether the "fair value of an insurer's liabilities depends on what assets it holds ... (or) is independent of the composition of its assets." FASB also noted that there was no consensus as to whether the "cash surrender value should be a minimum level for the fair value of liabilities." Unfortunately, I doubt that we, as actuaries or as an industry, are much closer to a consensus on these issues today than we were when *FAS 115* was released in 1993.

Now that we have covered what FASB itself thought about marking liabilities to market, let's review the initial response of analysts in the industry to the standard. Before *FAS 115*, noninsurance companies valued nonmarketable equity securities at cost. Marketable equity securities (MESs) were held at the lower of cost or market (LOCOM). Unrealized gains were included in income for current marketable equity securities, but not included for noncurrent marketable equity securities.

For insurance companies, however, fixed income investment portfolios were carried at amortized cost with market values disclosed, while equities and fixed income trading portfolios were carried at market value with historical cost disclosed. Both the pre- and post-*FAS 115* systems are mixed cost market systems that cause analysts to adjust the financial statements.

The semistrong form of the efficient markets hypothesis (EMH), says that security prices fully reflect all publicly available information. In other words, it does not matter if information is merely disclosed or actually included as part of the balance sheet or income statement. So from the perspective of the EMH, marking assets to market and not marking liabilities to market really shouldn't impact stock prices of an insurance company or any other company with assets and liabilities.

The initial informal industry reaction to *FAS 115* was that both sides of the balance sheet should be marked to market for the sake of consistency. This position was typified by a July 6, 1993 letter to FASB signed by twelve insurance company chief executive officers (CEOs) that urged FASB to undertake a high priority project to develop a methodology for marking life insurer liabilities to market.

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However, this initial reaction was not unanimous. The *Record of the Society of Actuaries*, Vol. 20, No. 1, which covers the Spring 1994 Orlando Meeting, includes an interesting question and answer time given at the end of a session on market value accounting. During that session, some skepticism was registered about how valuing liabilities at market may introduce even more volatility into the balance sheet. The view that *FAS 115* was not a big deal was also expressed -- a view that implies that valuing liabilities at market is not necessary.

The view also is expressed that the current system is broken, -- really broken after *FAS 115* -- and it doesn't make sense to patch it together to keep it going; we should start all over with something new. Also, the fact that we have the held-to-maturity category and the Securities and Exchange Commission (SEC) deferred policy acquisition cost (DPAC) adjustment (i.e., the "shadow deferred acquisition cost or DAC), mitigates much of the volatility caused by *FAS 115* to the point that determining fair value of liabilities may not be necessary.

If a system to account for liabilities at market value were to be incorporated into the GAAP framework, I wonder if that system would account for each of the different types of financial liabilities in a consistent manner. If so, then market value accounting would be very different from the current system where different liabilities are accounted for very differently. Bank and thrift liabilities are not accounted for in the same manner as most insurance company liabilities. Even insurance company liabilities are not accounted for in a uniform manner. Sometimes premium is revenue. Sometimes it is not. Sometimes there are DPAC assets. Sometimes there are not.

When there is a DAC, it may be amortized in proportion to investment income, premiums, or gross profits depending on the product. Sometimes the benefit reserve is an account value, a net premium reserve, or the present value of future benefits. When the reserve is the present value of future benefits, sometimes the interest rate used to calculate the present value is locked in, and sometimes it isn't. Sometimes there's a provision for adverse deviation. Sometimes there isn't. Sometimes there's a cash value floor to the benefit reserve and sometimes there isn't.

While investment contract fair values are shown in the notes to the financial statements, there is no such requirement for insurance contracts. These inconsistencies may be carried over in any fair value for financial liability system. If so, no single fair value methodology will work for each different kind of liability. If it's not carried over, then not only would a fair value system result in fair values, but also it would bring about the more radical result of accounting for all types of financial liabilities in the same way.

Fair valuing methodologies for financial liabilities can comprise several categories: discounted cash flow or option pricing methods; actuarial appraisal methods; mitigation methods; and methods that minimally amend the existing accounting framework, which I call the band-aid approach. Discounted cash-flow or option pricing methodologies have been coined as constructive methods in the monograph produced by the American Academy of Actuaries Task Force on the Fair Value of Liabilities, which was chaired by Jim Hohmann. I presume that the term *constructive* was used because, given certain cash flows and interest rate scenarios, the fair value of the liabilities can be constructed.

These constructive approaches generate cash flows that can vary by stochastically generated interest rate scenario, which then discounts these cash flows back at the risk-free interest rate for each scenario, plus a spread to reflect risk such as liquidity and the insurance company's credit. If only a single scenario is used to generate and discount these cash flows, an additional spread is added to reflect risk aversion. Alternatively, a fixed spread can be found that, when added to the risk-free rate, gets the present value of future benefits and expenses equal to the present value of future considerations. The monograph I just mentioned is available from Cheryl Padilla of the Academy of Actuaries.

Actuarial appraisal methods are coined as "deductive" in the Academy monograph. Life insurance company actuarial appraisals are based on the present value of the net cash flows available to shareholders after an adjustment for statutory reserve and required surplus changes. The appraisal value can be deducted from the value of assets to determine the fair value of liabilities.

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Mitigation methods mitigate the volatility caused by including assets at fair value in the balance sheet. These methods do not necessarily calculate the true fair value of liabilities. Examples of this approach include incorporating a type of statutory accounting interest maintenance reserve (IMR) adjustment into GAAP, or setting the fair value of liabilities equal to the book value of liabilities multiplied by the ratio of the market value of assets to the book value of assets backing those liabilities. These methods begin by assuming that cash-flow-testing analysis already shows that the book value of assets is adequate to fund the book value of liabilities. The SEC shadow DAC amortization adjustment is another example of a method that mitigates the volatility caused by *FAS 115*.

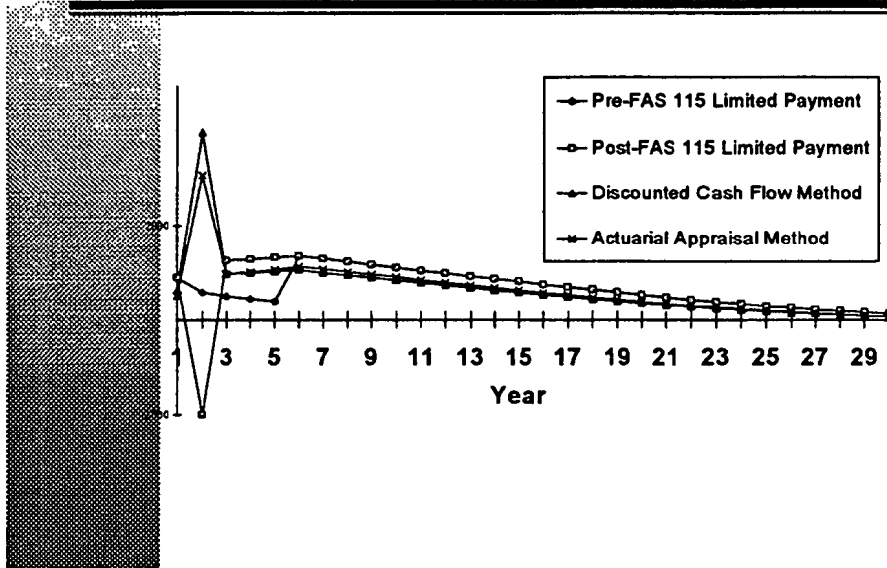
Finally, there are methods that minimally amend the existing accounting framework. One method is to define the term "lock-in" under *FAS 60* as applying to the spread over the Treasury curve rather than the actual discount rate itself. That is, to value an *FAS 60* liability at a later duration, you would add the spread that was in effect at the inception of the liability to the Treasury curve in place at that time. Another method is to give even more mitigating power to the SEC shadow DAC amortization adjustment by allowing the DPAC to exceed the accumulated value of DACs.

This has been a brief overview of these methods. A more detailed description can be found in the Academy monograph. Also, Irwin Vanderhoof of New York University and Warren Luckner of the Society of Actuaries are preparing a seminar on this topic to be held at New York University on December 7-8, 1995. Registrants for the seminar will receive a preliminary copy of the papers resulting from the Society of Actuaries call for papers on the subject. Authors of the papers and discussants from outside the actuarial community will speak at that conference. Eventually, Richard Irwin Publishers will publish the papers, the discussion, and the proceedings of that conference.

Now, Chart 1 is a graphical example of how the pre-*FAS 115* accounting, post-*FAS 115* GAAP, and possible constructive and deductive methods would work for several different insurance contract liabilities. The example assumes a ten-year certain single premium immediate annuity (SPIA) with benefit payments extending over 30 years. We are supporting this liability with a five-year bond, and we're in an 8% interest rate environment. Assume we're two years after issue. At that point, the

CHART 1

**SPIA with Five-Year Bond
Contribution to SPIA GAAP Equity
Interest Rate Jump From 8% to 10% at End of Second Year**



duration of the liability is about nine years, and the duration of the assets supporting this liability are less than three years.

It would seem, since assets are shorter than liabilities, that an increase in interest rates would result in an increase in the economic value of equity. The line with diamonds shows what happens under the old pre-*FAS 115* accounting. This SPIA contract is defined as a limited payment contract under *FAS 97*. These contracts have an unreleased profit reserve (UPR), that levels out the contribution to GAAP equity over time. Under pre-*FAS 115* accounting, contribution to GAAP equity remains fairly level for the first five years. In the sixth year, the 8% bond matures, and proceeds are reinvested at 10%. The extra investment income results in relatively more contribution to GAAP equity in years six and later than in the early years.

Now look at the line that portrays contribution to GAAP equity under current post-*FAS 115* accounting. Since assets are valued at market and interest rates increased in the second year, there is a large deduction in GAAP equity in the second year. However, the deduction is spurious in the

sense that, as I just noted, an interest rate increase actually improves economic value. So economic value goes up, but under current GAAP accounting, GAAP equity takes a hit.

The line for the discounted cash flow, or constructive method, captures the drop in the value of the liability. There is a big drop in the market value of a liability, and so there's a big contribution to GAAP equity; that's the line that more accurately reflects what truly happens on an economic basis. Actuarial appraisal, or deductive methods, would show similar results as the discounted cash flow method. The actuarial appraisal method notes that, because interest rates went up, the present value of future distributable earnings goes up, and we have a big increase in the contribution to GAAP equity.

Chart 2 is the balance sheet analogy to the previous graph. This chart shows projected GAAP equity rather than the projected contribution to GAAP equity.

Now let's take a look at a different kind of liability -- traditional whole life (Chart 3). In some ways, this example is simpler because the interest rates are 8% for the full term. What I want to demonstrate is that discounted cash flow (constructive methods) are good for investment contracts, and they seem to work well for single premium insurance contracts, but they don't work very well for repetitive premium insurance contracts. They tend to back-end contributions to GAAP equity for this type of product.

Here, the line with diamonds shows what happens under old accounting, which is the same as current accounting in this example because interest rates aren't moving. The other line shows what would happen under discounted cash flow or constructive methods. Discounted cash-flow methods have contribution to GAAP equity emerging in proportion to investment income. Investment income emerges pretty much in proportion to assets, as assets substantially mirror liabilities. For a traditional life policy, there are low reserves in the early years, and they increase by duration.

The current accounting line works the way you think it should, and it works the way it would for *FAS 60*. For instance, in the 20th year we only have about 20% of these contracts remaining. Everybody

CHART 2

SPIA with Five-Year Bond
 SPIA GAAP Equity
 Interest Rate Jump from 8% to 10% at End of 2nd Year

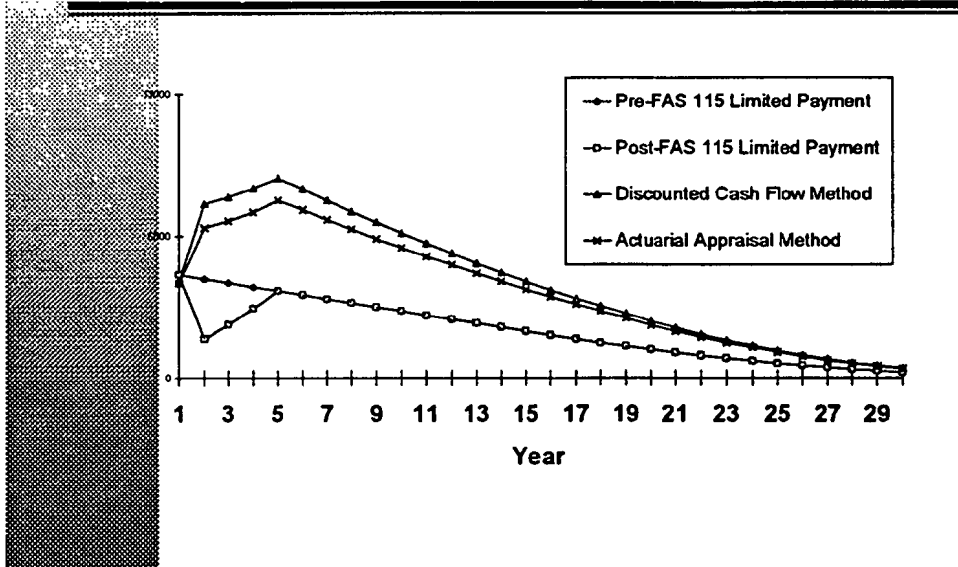
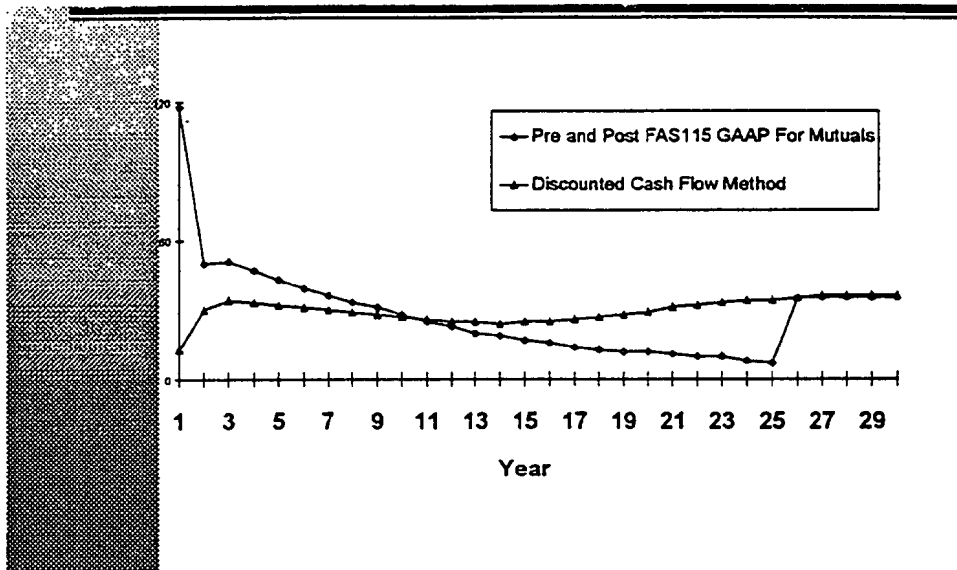


CHART 3

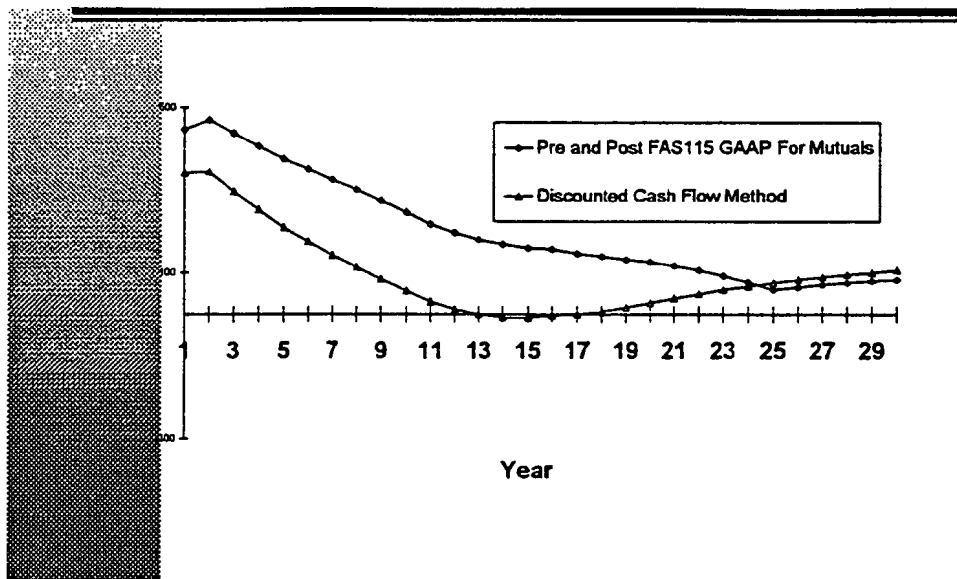
Traditional Whole Life with Ten-Year Bonds
 Contribution to Traditional Whole Life GAAP Equity
 Interest Rates Constant at 8%



else has surrendered or died, so it makes sense that contribution to GAAP equity would decline from year to year. But under the discounted cash-flow methods, it's not declining from year to year.

The discounted cash-flow methods, in a sense, treat the whole life policy as a whole series of single premium life policies, and the contribution to GAAP equity per policy actually grows. These constructive methods back-end contributions to GAAP equity for noninvestment contracts and insurance contracts that are not single premium or limited premium. Chart 4 is the balance sheet analogy to the previous chart. The line with diamonds is the old accounting, which is the same as the current accounting, since interest rates don't change, and it has a higher GAAP equity than the proposed constructive method.

CHART 4
Traditional Whole Life with Ten-Year Bonds
Traditional Whole Life GAAP Equity
Interest Rates Constant at 8%



Now I'd like to discuss symmetric value a little bit. Holders, issuers, underwriters, and potential buyers and sellers place different values on a good. A policyholder must value a policy at least at the cash value. Otherwise, the policy could just be surrendered and the policyholder would get the cash value. The insurance company, on the other hand, theoretically could value that policy at less than the cash value. So you have asymmetric value. The policy is worth more to the holder of the policy

than it is to the insurance company. When a potential buyer places a higher value on a good than a holder, there is potential for a market transaction. When the market is thick, the equilibrium value or price can be determined. When the market is thick, you'll have a low bid-ask spread, and you'll be able to find the market clearing price.

Take, for example, the stock market. Currently, General Electric stock is selling for \$60.63. If you own it and somebody offered you \$70 for it, you would take the \$70, run right back to your broker, buy the stock for \$60.63, and pocket the extra \$9, which you'd be able to do unless there was an extraordinary market move all of the sudden. The same applies to somebody like myself who doesn't own General Electric stock. If somebody offered to sell it to me for \$50, I would buy it, run to my broker and sell it for \$60. I can do that because the market is thick. There's a low bid-ask spread.

But with insurance contracts, the market isn't thick. It's very thin because there's a large bid-ask spread. I have a two-year-old traditional life insurance policy. I invested about \$6,000 into it, so to me and my family, the policy is worth \$6,000. It should be or else I shouldn't have put \$6,000 into it by now. My asking price for it is \$6,000, but the only one that's bidding is the insurance company. The cash value is zero right now, and I have some paid-up additions that are only worth a few hundred dollars, so the bid-ask spread is really huge. The market is thin, so we can't find the place where the supply-and-demand curves cross, e.g., the market clearing value.

When you don't know what the value is, you can back into it if you know what the interest rates and the cash flows are. Likewise, you can back into the interest rate if you know the value and the cash flows. But we don't have a consensus on the interest rates or the value for the insurance policy. When there is a thin market, oftentimes there is a replicating portfolio constructed by a linear combination of other assets. But can anybody come up with a linear combination of assets that can exactly mirror my life insurance policy?

Yield curves typically slope upward. Valuation rate curves typically slope downward. Now, there has been talk in the industry and the actuarial community about what the spread should be over the Treasury curve to discount liability cash flows. Dave Becker had a teaching session on this at the

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1994 Orlando Spring Society Meeting. One possibility is not to use any spread at all. To get fair value, you could use Treasury rates, or the same spread as the assets backing the liability. You could also use the liability spread, which is the spread added to the Treasury curve so that the present value of future benefits and the present value of future considerations are equal at issue.

Another possibility is to use the company's credit rating to come up with a spread. That's a default spread. The Academy monograph also has a discussion about what kind of spread to use. In any event, yield curves typically slope upwards, and the valuation curve typically slopes downward. I have, for instance, a New York circular letter that states what interest rates to use to value a liability. This is statutory reserving, but it says for a five-year Type A guaranteed investment contract (GIC) issued in 1990, use 8%, and use 5.75% if it's a GIC that's guaranteed for more than 20 years. Hence, the valuation rate curve slopes downward. That's statutory reserving, but GAAP reserving is much the same story. An actuary valuing a policy might use a high valuation rate for the earlier years and a lower one for later years, maybe providing a provision for adverse deviation.

Why does the yield curve slope upwards? It could be explained by the pure expectations hypothesis that says that forward rates reflect the market's best expectation of future short-term rates. The liquidity preference theory says that short-term rates tend to be lower, because we need more interest if we're going to tie up funds for a longer period of time. The capital asset pricing model says the expected return on a financial instrument equals the risk-free rate plus beta, which is a term representing nondiversifiable systemic market risk, times the difference between the expected return on the whole market portfolio and the risk-free rate.

Now, stock returns are negatively correlated with interest rates. That's true in every country: the U.S., England, Canada, Germany, and Japan. Some research that demonstrates this is in an article by Solnick in the late 1983 *Journal of Finance*. What I'm trying to show is that bonds have some systemic risk. Since interest rates are negatively correlated with stock prices, bonds are positively correlated with stock prices. The longer the bond, the higher the covariance between the market returns on the portfolio and the bond. This indicates that a longer bond should have a higher discount rate, which helps to explain why the yield curve slopes upward.

We have two senses of time. Are spreads constant across the yield curve? No. An AA-rated bond might have a 40 basis point spread over Treasuries for a two-year bond, but it might be 80 basis points for a ten-year bond. I would suggest that that's probably true for the spread between the valuation rate and Treasury rate. I would say that, perhaps, the spread between the valuation rate and the Treasury rate is maybe 30 basis points for a short, one-year liability; but perhaps it's negative 100 basis points for a long liability. One assumption underlying the discounted cash flow or constructive methods is that that spread at issue stays constant over time, but may vary by duration.

One popular view is that strong companies should have a lower valuation rate than a weak company. A weak company with a low credit rating may not pay off, so therefore it should have a high valuation rate. That makes sense, from a policyholder standpoint, but does it make sense from the company's standpoint? Let me give you an example.

Suppose you have two companies with an identical asset and liability. One company is rated high. The other one is rated low. One company has better management than another. They both have the same asset, a \$10 perpetuity, an asset that pays \$10 a year forever. The market value of the asset is \$100. The yield on the asset is 10%. They also have the same liability that results in a \$9 benefit payment every year forever.

What's the value of the strong company? It's a strong company, so let's use a low hurdle rate: 12%. The distributable earnings are \$1 a year forever. A dollar a year discounted back at 12% results in an \$8.33 value of the company. Therefore, the value of the liability, the implied value, is \$100 for the asset, minus \$8.33 for the company as a whole, which results in a \$91.67 value for the strong company's liability.

For the weak company we're going to use a higher discount rate: 15%. The value of the company in that case would be \$6.67. A dollar a year discounted back at 15% equals \$6.67, which results in a \$93.33 implied value of the liability. The implied valuation rate for the strong company is 9.82%. The implied valuation rate for the weak company is 9.64%. So the strong company gets the higher valuation rate, which is counter to what I've heard often expressed.

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How to explain that? I'm not sure how to explain it, but I'm going to borrow a concept that Dave Babbel from the University of Pennsylvania Wharton School mentioned at the Society of Actuaries Advanced Asset/Liability Management Program earlier in 1995. He proposed a concept of enterprise value and financial risk value. You have a company that's perfectly asset/liability matched, which is on the left side of Chart 5. He would show that this company has a high value. It has more potential sales, less regulatory pressure, better morale, and more security. The company has a good value.

If that company were mismatched more, the value of that company would keep dropping unless the company was really mismatched in a major way, in which case the value starts going back up again. It has financial risk value, because then the company is just like buying an option. If things go the right way, the asset/liability mismatch works favorably for the investor. If things go badly, the investor doesn't lose anything.

If you're at the right end of Chart 5, the idea that weak companies have high valuation rates holds. But if you're at the left end of this chart (even most weak companies are at the left end of the chart), then you can't make a good argument for weak companies having higher valuation rates.

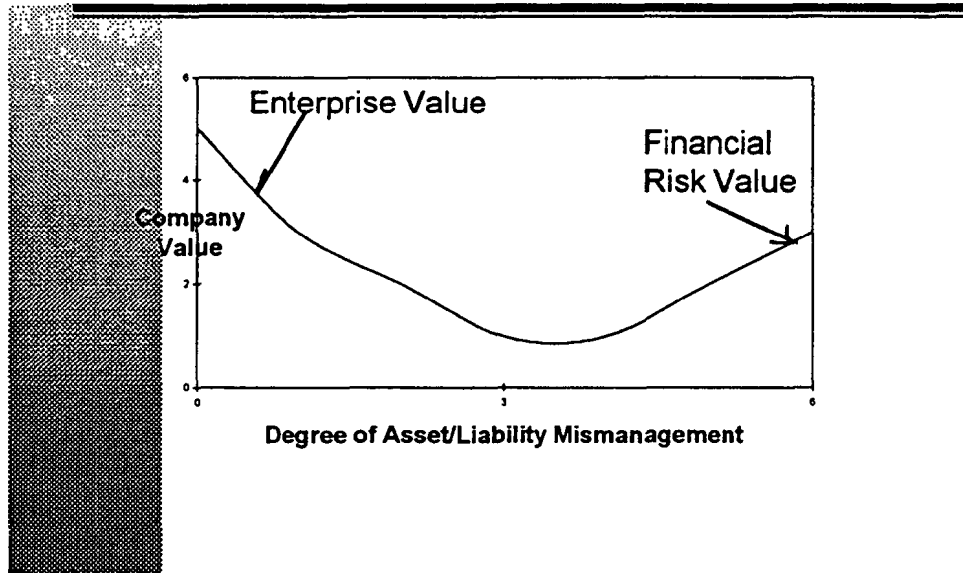
There are several different kinds of empirical accounting research. One is the classical approach. The classical approach evaluates methods in terms of how close provided information is to the preconceived true picture of the firm. But, everybody has his own idea of the true picture of the firm. Let me quote from *The Analysis and Use of Financial Statements* by White, Sondi, and Freed:

"Under the old classical approach to empirical accounting research, notions such as economic profit and its relationship to accounting income are the focus of the debate. Thus, much discussion without consensus ensues over topics such as current cost versus historical cost accounting frameworks."

That's the debate we're having today. The authors go on to quote another fellow by the name of John Canning who said, "What is set out as a measure of net income can never be supposed to be a fact in any sense at all, except that it is the figure that results when the accountant has finished applying

CHART 5

Should Valuation Rates Be a Function of Company Credit Rating?



the procedures which he adopts." The classical approach is not testable. It fell out of favor among academics by 1970, but it still underlies the basic accounting framework. If we go to another phase accounting research approach, we could resolve this debate a little bit easier.

MR. JAMES D. WALLACE: What we're going to cover next are implementation issues that arose from *FAS 115*, and then a few more GAAP issues that are currently emerging.

FAS 115 caused great changes in the way we account for our investments. In particular, let's focus on bonds. Basically, you are required to break your bond portfolio into one of three categories: "held to maturity," where you continue to hold the bonds at amortized cost; "available for sale," where the bonds were carried at fair market value and unrealized gains and losses go through equity; or a "trading account," where bonds would be held also at fair market value, but unrealized gains and losses would go through income. Those are the three choices.

The rules received, as George indicated, a fair amount of criticism, because they didn't permit the fair market valuing of liabilities, only assets. We're going to talk about what that did to financial

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statements here in a bit. In late 1993, a survey was done of a large number of insurance company CEOs. The survey results were that the CEOs believed they would mark about 55% of their securities into available for sale compared to 25% that were already in available for sale, that is, carried at fair market value, prior to *FAS 115*.

Later surveys, though, show that it's closer to 70-75% of the insurance industry's bonds that are in the available-for-sale category, so it's a very important category. The question was asked to what extent would *FAS 115* influence companies to place a higher priority on accounting results versus maximizing economic value -- to what extent was accounting going to drive economics? A full 25% of the CEOs responded that *FAS 115* would have a moderate amount of impact on operations.

Similarly, the CEOs were asked to what extent the tendency to manage for accounting results would cause a shift in the company's business strategies. Again, the results were consistent. A full 25%, a quarter, of the respondents said, at least to a moderate degree, that *FAS 115* would cause a shift in the company's business strategies.

Let's go through some of the subsequent clarifications of *FAS 115* and how companies actually dealt with some of the implementation issues. The first one, and one of the more complex announcements to interpret, came from the SEC in January 1994. The SEC indicated that companies should adjust policyholder liabilities, DAC, and the present value of future profits for *FAS 97* products to the extent those amounts are backed by assets available for sale.

In other words, say a company had bonds that had been identified in the available-for-sale category. As a result, they were carrying those bonds at market and running the unrealized gains through equity. Any unrealized gains or losses at the end of an accounting period, were to be considered as realized in the gross margins. Then you were to determine the impact on the amortization of DAC, and that impact, attributable only to the unrealized gains or losses, was charged directly to equity. One benefit of this is it did have a mitigating effect on the amount of the unrealized gains and losses; and we'll look at that in more detail in a minute.

One of the more controversial aspects of the rule was that the SEC said to the extent that realized gains were contractually obligated to pass through to policyholders, so too were unrealized gains to be treated for accounting purposes. To the extent you had unrealized gains and losses, reserves could be adjusted. There are certain pension contracts that clearly pass through realized gains and losses. So, to the extent that there were unrealized gains and losses, those unrealized gains and losses would also be added to reserves. Again, it would mitigate the impact of the unrealized gain or loss.

Some companies have become fairly aggressive with this. Some companies have considered appropriate the deferral of unrealized gains and losses, as well as realized gains and losses, pursuant to this particular announcement by the SEC, if they could demonstrate a consistent past practice of passing realized gains and losses to policyholders. For example, maybe the company had a history of utilizing realized gains to subsidize future credited rates on deferred annuities and universal life (UL).

FAS 115 got more clarification in March 1994 when the FASB issued through the Emerging Issues Task Force (EITF), EITF-9318. The focus of EITF-9318 was on interest only (IO) collateralized mortgage obligations (CMOs), derivatives. If the cash flows that you anticipated under those securities discounted at a risk-free rate were less than the carrying value, you had to take a write-down. Prior to this EITF, as long as the sum of the undiscounted future cash flows of an IO equaled your carrying value, there was no write-down. Now you were forced to take a write-down so that you would earn the risk-free rate prospectively.

Theoretically, if you had big unrealized losses, and if those unrealized losses were put in your gross margin schedules, that would cause DAC to pop up because of diminished cumulative gross margins. The SEC hadn't contemplated that because, when it clarified *FAS 115*, companies had big unrealized gains. So shortly thereafter, when suddenly all those unrealized gains turned into unrealized losses, the question arose whether it cuts both ways: that is, should unrealized losses give rise to a pop up in DAC because of their diminishing impact on gross margins? The answer was yes, but there's a ceiling: you can't restore DAC above the original amount deferred plus the accretion of interest.

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I was interested in George's comment that one mitigating impact for valuing liabilities might be to remove that cap, but clearly that cap is there for GAAP now. You can't write your DAC back up above the original amount deferred plus the interest that would have accreted since those costs were incurred.

In January 1995 at the American Institute of Certified Public Accountants (AICPA)/SEC Annual Conference, which is heavily attended by the accounting profession, the SEC made it clear that it expected reasons to be disclosed in the footnotes for any transfers or any sales of a security that were put in the held-to-maturity category. You may recall in your own companies and in the trade presses it was made clear that, if you classified a security as held to maturity so that you could carry it at amortized cost and sold even one of those securities for just about any reason, it would taint the entire portfolio, and you would be forced to mark all of your held-to-maturity securities to market.

The SEC expected that, when one of these very rare transfers or sales occurred, the reasons would be disclosed, which would give the SEC and any reader of the financial statement the ability to analyze and judge for themselves the appropriateness of the sale. The SEC, again, just made clear that held to maturity means exactly that -- held to maturity. You can't sell securities out of the held-to-maturity category or transfer them, except for some very limited reasons that are set forth in paragraph 8 of *FAS 115*.

The SEC indicated, in fact, that the sale or transfer of one security would taint all the remaining securities, and they could all be reclassified to available for sale and immediately marked to market. The SEC also indicated informally that once tainted, once you had sold one security that was in your held-to-maturity category, then that category simply wouldn't be available to your company for new purchases or transfers for a period of one to two years. You really can't play around in that category.

I think it is an extreme position that the SEC even said that, even if a company receives a tender offer for a security with greatly sweetened attributes and the company were to sell the security that was in the held-to-maturity category pursuant to a sweetened offer, that would also taint the whole category. So, a company issues a bond. Maybe there's a modest call premium, but the company that

issued the bond wants it back, and it offers a dramatic call premium or some other sweetened basket of securities to get its bond back. Well, if you sell your bond in response to this sweetened offer, which you had never contemplated when the bond was purchased because such an offer didn't exist, that would taint the held-to-maturity category.

When you have big unrealized gains on your available-for-sale portfolio, that obviously will increase your equity. But one of the adjustments you would make, besides amortizing DAC or putting amounts in policyholder liabilities, is a deferred tax adjustment. If you have big unrealized gains, you might reduce those unrealized gains by a third for deferred taxes; so that the net amount going through equity would only be two-thirds of the original unrealized gain amount.

When those big unrealized gains turn to unrealized losses, a whole new set of questions arise. One such question is, what if I have a huge unrealized loss that gives rise to a deferred tax asset? If I were to sell those securities, I would have a big loss and presumably get a big tax break for that. The answer was, yes, you could go ahead and set up a deferred tax asset. That's fine, but can you recover that deferred tax asset? If you suddenly had a billion dollars of realized losses, how are you going to realize the tax benefit in its carryforward period? Those big realized losses might expire before you can find a strategy to realize the tax asset. So, if you are able to recover that tax asset, you must reserve for it and set up an allowance. That's the easy part.

Here's where it gets complicated. The unrealized loss on the available-for-sale portfolio would go through equity. The deferred tax asset that you set up would also go through equity. So far, so good. If you reserve for that deferred tax asset, i.e., set up an allowance for it because you are not able to get all those taxes back, that would also go through equity. That's all fine. But suppose that you believed when the unrealized losses occurred and you set up the deferred tax asset that you could recover the deferred tax asset?

As a result, you run the unrealized losses and the deferred tax liability through equity. But in some future accounting period, say two years later, your facts change. The unrealized losses are still there. The deferred tax asset is still there, but you say, "I really can't recover that. After I realize these

losses, I'll never get the benefit of the tax asset." Then, when you set up a valuation allowance for that tax asset, you have to run it through income, even though it could have gone through equity had you put it up a couple of years ago.

As a result of that, some companies decided to fully reserve for the whole tax asset under the theory that its better to be safe than sorry. So at a later date, when we realize we don't need the deferred tax asset allowance -- that we will be able to recover the deferred tax asset -- companies take that allowance down through income and manufacture income. You want to be careful about that, and I think that will get challenged, but I do think companies were appropriately conservative in providing allowances against the deferred tax assets.

In a very recent interpretation or clarification, the SEC and FASB have made it clear that general reserves for bonds are prohibited by *FAS 115*. What this means is you can't set up a general unspecified allowance for potential bad bonds in your portfolio. If you're going to take a write-down, you have to identify the particular bond you're taking your write-down on. Once that bond is written down, it can't be written back up. No longer are you allowed to have a general allowance against potentially bad bonds. That ties your hands a little bit.

Let's look at the impact of all of this on actual numbers. What did *FAS 115* do to financial statements? If you looked at the ratios of the fair market values of the bonds to their amortized cost for a large segment of the life insurance industry, you would find, to no surprise, that on December 31, 1993, the fair market value exceeded amortized cost by about 6%. The exact ratio was 105.8%. By December 31, 1994, as an industry we were "underwater," and so the fair market value was about 5% less than the amortized cost, or 94.6%.

The separate component of equity, that's the unrealized loss less the DAC amortization, less the deferred tax asset, equaled about 57% of the unrealized loss. So if you had \$100 of unrealized loss in your portfolio, you only had to charge \$57.40 on average against equity. So much of it was mitigated.

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Most DAC portfolios were underwater at year-end 1994. The majority of companies were providing at least some allowance against the deferred tax asset that arose, but some companies encountered another problem that was unforeseen. There was another limit on how much you could allow your DAC to be written up, as a consequence of the unrealized losses; and that is the limit of recoverability. If you're five or ten years down the road on a contract and have big unrealized losses on a *FAS 97* contract and you're allowed to pop up your DAC, all the way back up to your original cost deferred plus accrued interest for the last five or ten years, there's a good chance you can't recover that asset. So there was another limit that people ran into, which was recoverability. The asset is subject to recoverability even though any adjustments would go through equity.

Let's look at the real numbers that I've been promising. I just picked at random three very large stock life insurance companies. They're all household names. All the numbers you're going to see are public numbers. I won't identify the companies, but these are all public data that you could get out of a shareholder report. I picked three very large stock life companies that you would all be familiar with, with investment portfolios of at least \$20 billion apiece.

Look at Company A in the 1993 column (Table 1). The market value exceeded book value by \$1.6 billion. Of course, that all ran through equity, so equity increased by \$1.6 billion. There was a DAC adjustment that offset that a bit, \$554 million, about a third.

This company made no adjustment for policyholder liabilities. That's a fairly rare adjustment in my experience. They provided a deferred tax liability of \$364 million. You'll find that's about 35% of the net of the \$1.6 billion and the \$554 million, which makes sense. So even though Company A had \$1.6 billion of unrealized gains, equity was increased by about \$676 million.

Just a year later, the \$1.5 billion of unrealized gains suddenly turned into \$1.4 billion of unrealized losses. That gave rise to a DAC adjustment in the opposite direction. That's a pop up in DAC. It's also about a third. Again, there was no policyholder liability adjustment. Then there was a deferred tax asset put up for the benefit of all of those unrealized losses. This company assessed the likelihood

TABLE 1
Company A
(\$ millions)

	1994	1993
Unrealized Loss	(1,387)	1,594
DAC Adj.	401	554
Policyholder Liab.	0	0
Tax	351	(364)
Tax Allowance	<u>(315)</u>	<u>0</u>
Equity Adj.	(950)	676

of being able to recover that tax asset and reserved heavily for it, which is a reasonable thing to do. Company A reserved almost all of it, and so equity was negatively impacted by \$950 million. In the one-year swing, because of *FAS 115*, the company experienced a \$1.5 billion decrease in equity.

Company B (Table 2) is interesting for a different reason. It began with almost \$2 billion of unrealized gains in 1993, which turned into about \$460 million of unrealized losses at the end of 1994. This particular company did have a policyholder liability adjustment with respect to its unrealized losses. Now, the nature of that wasn't disclosed, and so I don't know what it was, but it's not uncommon for stock companies that write participating business and who are subject by New York or by other statute to pay 90% of the earnings to the policyholders on a participating block.

It's not uncommon to take 90% of all your realized gains and put them in policy reserves as they arise, because you're going to have to pay them out. Likewise, when you have unrealized gains, those would also have to be reserved under *FAS 115*. I suspect that's what it is. So this adjustment does occur.

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TABLE 2
Company B
(\$ millions)

	1994	1993
Unrealized Loss	(460)	1,929
DAC Adj.	162	(429)
Policyholder Liab.	14	(58)
Tax	108	(497)
Tax Allowance	<u>(136)</u>	<u>0</u>
Equity Adj.	(312)	945

Company C (Table 3) is more of the same. It's just an example to show the magnitude of the numbers. This particular company had a smaller portfolio that it identified as available for sale. It had some held to maturity. This one is interesting because it saw no need for a tax allowance. There could be very good reasons for why you wouldn't provide for a deferred tax allowance. Again, there's a pretty dramatic impact on equity.

The industry's response to all of this was a desire to mark liabilities to market. Unfortunately, I think that we are the only industry that's still pushing that with any great fervor. Some companies considered putting a fair market value balance sheet in the footnotes, which you're allowed to do. You can't mark your liabilities to market on the face of the balance sheet, but you were allowed in your footnotes to put together a full-blown fair market value balance sheet, and a number of companies actually did that.

In fact, *FAS 107* requires you to disclose the fair market value of investment contract liabilities, so a good chunk of fair market values had to be disclosed in the footnotes anyway. If you could pull all fair value information together -- including the few items that weren't required to be fair market valued -- you could assemble a fair market value balance sheet, and a few big stock companies did do that.

TABLE 3
Company C
(\$ millions)

	1994	1993
Unrealized Loss	(609)	468
DAC Adj.	79	(42)
Policyholder Liab.	0	0
Tax	185	(147)
Tax Allowance	<u>0</u>	<u>0</u>
Equity Adj.	(345)	279

That's it on *FAS 115*. I do want to cover a few more accounting releases that may or may not be of some interest to you. The first one is the guarantee fund statement of position (SOP). This is not necessarily an actuarial item, but obviously it applies to our industry. As you know, guarantee fund assessments are getting gigantic. They have been for the last few years. As they began to materialize, the question was raised how to account for guarantee fund assessments on a GAAP basis. Should we accrue for them or shouldn't we? If we accrue for them, how do we do it? We have no idea how big the loss is. Even if we knew the loss, in a lot of states you get assessed on premiums that you write in the year of assessment, which is in the future, rather than in the year the loss arose. There were all kinds of questions.

Some companies believed, following *FAS 5*, you should accrue for that loss, and some companies did. They made their best estimate and accrued it. Other companies didn't accrue any amounts and disclosed that in their financial statements, also believing they were following *FAS 5*, given the inability of the company or anybody to reasonably estimate what the liability should be.

The AICPA Insurance Companies Committee met on the topic and produced what's called an SOP to account. The notion was to get FASB to approve the contents of that SOP, which were that you should accrue for an insolvency when two things have occurred. One, you have to know that there is an insolvency. You don't have to anticipate one. If companies look bad, you don't have to accrue

for that. You wait until a company goes bad. The second thing is that the event that determines your individual share of the insolvency has to have occurred. What does that mean? If you're assessed based on premiums that you wrote during the years that the insolvency occurred, then that event has occurred. You know what your premiums were. You know that the insolvency has occurred. You would have to accrue for that. If, on the other hand, your assessment is based on future premiums that you're going to write after everybody figures out how deep the hole is, then you wouldn't accrue yet because you might not write any premiums, and if you do, you don't know how much you're going to write.

That was the AICPA Insurance Companies Committee's position. That went to the Accounting Standards Executive Committee (AcSEC), which is an important accounting body. Its members approved the position. It was sailing through the process. It got to the FASB, but the FASB had just changed its approval rules. The FASB voted four to three in favor of the proposal, but the rules changed shortly before to require a five-to-two majority, and so this SOP was rejected.

The reason it was rejected was the FASB thought that once an insolvency had occurred, you ought to accrue your liability regardless of how the allocation of liability is determined. So this is back to the AICPA Insurance Companies Committee, and its members don't know what they're going to do with it yet. They may still try and get it passed. This is a good issue to monitor.

I presume you know a lot about Mutual GAAP. It's obviously another new pronouncement. It sprang from Interpretation 40, requiring mutuals to follow all the FAS's that apply to them. It's codified under *FAS 120*. If this affects you, you probably have been working pretty hard on this for some time now. It certainly has the mutuals busy.

The only new thing with respect to mutual GAAP that hasn't happened yet is SOP 95 "something." We don't know the number yet because it hasn't been adopted, but there will be a new SOP that will describe what an accountant's opinion can state with respect to statutory financial statements for mutuals. Currently if you're a mutual and you produce statutory financials, no GAAP financials, you get a clean opinion that says your financial statements are in accordance with GAAP, even though

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they're statutory accounting practices (SAPS), because the audit guide defines SAP as deemed to be GAAP for mutuals. That won't be permitted anymore beginning in 1996, so the form of the accountant's opinion hasn't yet been adopted by the AICPA. It's probably going to be an adverse opinion as to GAAP. It's probably going to say that SAP financials are not in accordance with GAAP, but then go on to say they are in accordance with statutory accounting principles.

There are two other SOPs that have some impact on us. SOP 94-5 was effective for 1995. Basically, if you have a significant amount of property/casualty (health is deemed to be property/casualty) business, you have to disclose in your footnotes information about your unpaid claim liability. This would disclose clearly and prominently to the reader of the financial statement what your redundancy or deficiency was in last year's unpaid claim liability. That shows the reader how well you can predict your unpaid claim liability.

The other impact of SOP 94-5 regards codification by the NAIC. Codification really arose because the Big Six accounting firms got close to saying they weren't going to give opinions on statutory financial statements because they weren't codified. Some people believe that statutory accounting principles don't constitute what's called an other comprehensive basis of accounting (OCBOA). For an auditor to give an opinion on financial statements, there has to be a set of rules. You can't make them up as you go. GAAP is clearly a set of rules. It's not so clear that statutory accounting principles constitute a clear set of rules, and so the AICPA applauds codification and hopes that process gets completed, so AICPA will feel more comfortable that statutory accounting principles constitute an OCBOA.

The issue that arose in SOP 94-5 was, why aren't statutory accounting principles an OCBOA? One of the reasons is that many commissioners permit certain practices that other commissioners don't; or a company may get permission to account for something in some unusual way that other companies in the same state aren't doing. You all know many examples of that. Auditors were required to get letters -- and you probably went through this if you have these policies -- from the commissioner where he signs off every year that any accounting practice you're following that's not a prescribed practice is a permitted practice. SOP 94-5 requires a disclosure of these. If you have

situations where statutory principles were approved that were not prescribed, they have to be disclosed.

SOP 94-6 is not effective until calendar year 1995. It's not uniquely an insurance SOP; rather, it applies to all industries. It requires the disclosure of the nature of the risks inherent in your business, the nature of estimates you have to make, and that's what actuaries do -- estimate things. It will result in a fair number of disclosures with respect to the operations of companies.

Deposit accounting is hot right now. If you're into reinsurance, especially annuities, GICs, or pensions, this may interest you. *FAS 113* has some pretty stringent requirements that contracts have to meet to be classified as reinsurance under *FAS 113*. If you don't meet the requirements of *FAS 113*, then you don't follow *FAS 113* for the purpose of determining how to account for a reinsurance contract.

What then do you follow? You follow deposit accounting. That would be fine if it were codified, but it isn't. Nowhere can you find a description of deposit accounting. This is a very big issue for the property & casualty industry. It has far more complex treaties, I think, than the life industry; and many of its treaties don't qualify for insurance and reinsurance under *FAS 113*. So there is a draft SOP that currently exists that describes what deposit accounting means for property & casualty insurance companies.

Well, this SOP has wafted up to FASB, and it appears that FASB is not going to consider the SOP unless life companies are wrapped into this as well. I can tell you that the Committee on Life Insurance Financial Reporting (COLIFR) of the American Academy is looking very hard into potential life issues with respect to deposit accounting for reinsurance treaties.

If you're aware of issues that your companies have encountered in accounting for a life reinsurance treaty that failed to qualify under *FAS 113*, COLIFR would be very interested in your anonymous facts; COLIFR's goal is to be involved in the drafting of this SOP and maybe influence it. Probably,

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the types of contracts that this applies to for life insurance are modified coinsurance treaties that don't transfer risk, or treaties covering investment contracts. They aren't covered by *FAS 113*.

The last topic, a new standard, is *FAS 121*. *FAS 121* requires a new set of procedures to be applied to what are called "long-lived assets" to determine whether they're recoverable. You often don't see goodwill tested much with respect to recoverability years after an acquisition. Goodwill and plant equipment, which we don't think of much in the insurance industry, but big manufacturing companies would, and other such long-life assets typically aren't subject to recoverability, as is, say DPAC.

FAS 121 requires you to subject long-life assets to recoverability. This is an odd kind of rule. While you're not required to go looking for assets that need to be subjected to recoverability, if you find some that may have a problem, your first step is to determine whether the sum of the undiscounted cash flows exceeds the carrying value of the item in the financial statements. If the sum of the future anticipated undiscounted cash flows is less than the item on the financial statements, then you have an impairment, and you write that asset down to market. How you determine market is not clearly defined.

A good example would be goodwill. When you have an insurance company acquisition, you set up the present value of future profits on the in-force business as an asset on the balance sheet. That's not goodwill, however. We know how to subject that asset to recoverability. To the extent you paid more or less in that acquisition than the net fair market value of the assets acquired, the balancing entity is goodwill. Typically, goodwill is approximately equal to the present value of future profits on the agency plant -- business not yet written. The value of new business is not an asset that GAAP recognizes, but nonetheless, it's the asset that essentially supports goodwill.

So, it may be that actuaries in the future will be involved in helping companies demonstrate whether goodwill remains a recoverable asset under *FAS 121*. It is clear that DPAC is excluded from the definition of long-lived assets. It appears that the present value of future profits on in-force business, by analogy, would also be excluded.

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MR. JAMES R. THOMPSON: Somebody mentioned the consequences of selling a "not-for-sale" *FAS 115* asset, and it was some exceptional condition. Now, if you do cash-flow testing or you encounter in real life a negative cash-flow situation, can you get rid of a not-for-sale asset?

MR. WALLACE: I think the answer is that if you sell a held-to-maturity security for any reason other than a reason set forth in paragraph 8 of *FAS 115*, then you've tainted the portfolio. You raise an interesting question with respect to cash-flow testing. If under your scenarios you have to liquidate securities, then how can you classify those as held to maturity?

That's a real issue. I don't believe that the thinking has evolved far enough yet to formulate a generally accepted rule, but, yes, it doesn't matter what the reason is. It doesn't matter how desperate your circumstances. If you sell a held-to-maturity security for other than the reasons listed in *FAS 115*, you risk tainting the portfolio. A credit downgrade is an allowed reason. A run on the bank is not.

MR. THOMPSON: I had another question about the ramifications of the accounting opinion under GAAP for mutuals. I read an article by a Mr. Vialis of Best's, and he implied that, although you might receive a qualified opinion, you might be able to keep your Best's rating if a company completed underlying experience studies that were comparable to what's done for the FASB.

MR. WALLACE: I surely didn't mean to imply that the absence of GAAP statements or a clean opinion would have anything to do with the Best's rating. That's a different topic. Just to clarify what I said, as mutuals continue to produce statutory statements as will be required unless the law changes, the law requires those financials to be audited in all of the states, and you're still going to have to get audited opinions on them.

What I said is that it will no longer be the nice, clean, three-paragraph opinion that says the financials are in accordance with GAAP. There's now going to be an extra paragraph that will state that these financials don't fairly present the position of the company in accordance with GAAP, but they do fairly present it in accordance with the rules prescribed and permitted by the NAIC. So, it'll end up

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as a clean opinion. It's just that you're going to have this awkward, additional paragraph that people are going to get tired of explaining to policyholders and others.

MR. DURAN: Company B in Table 2, Jim, had a deferred tax asset of \$108 million, and it managed to set up a reserve against that of \$136 million. Do you have any insight to explain that relationship?

MR. WALLACE: Yes, I know what it may be. This information is not necessarily required to be disclosed, and I only used public data, so the \$108 million may be the tax impact on the unrealized losses net of the DAC, but the \$136 million tax allowance could be the entire tax allowance. There could be all kinds of other tax attributes for which an allowance was provided besides unrealized losses, but I'm only speculating.