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Session 1
Introduction And Overview

Moderator: Charles D. Friedstat
Panelists: Stephen J. Preston
J. Peter Duran

Summary: This session provides a brief overview of a variety of financial reporting topics, most of which will be discussed in more detail at later sessions.

- *NAIC Life and Health Actuarial Task Force developments and directions, including*
  - *Progress towards new annuity nonforfeiture and actuarial guidelines*
  - *Actuarial guidelines: XXXIII, XXXIV, ZZZ, and ZZZZ*
  - *Proposed new disability valuation tables*
  - *Change to Actuarial Opinion and Memorandum Regulation/state variations*
- *XXX Implementation Status*
- *New annuity valuation tables*
- *Statutory codification project ¾ overview, timing, and implications*
- *American Academy of Actuaries developments, including practice notes*
- *Unified Valuation Systems*
- *FASB and SEC developments*
- *Recent tax developments*
- *Other recent emerging developments*

MR. CHARLES D. FRIEDSTAT: This session is a potpourri that gives people a little smattering of some of the developments that are going to be discussed in more detail at the later sessions. The way that the panel will be set up is Steve Preston will be talking about statutory developments. Steve is executive vice president and chief actuary with Golden American, which

is an ING company. Steve is extremely active in committees and Society of Actuaries and NAIC activities. He'll be giving you a basic summary of the events that have happened in the past year and some things that are currently ongoing. In response to some comments last year, I gave sort of an off-the-cuff tax developments presentation. We formalized it a little bit more in 1999. I'll be giving a very brief summary of some of the tax implications of some of the statutory developments that Steve talks about. Following that, our final speaker will be Peter Duran. Peter will be focusing on GAAP developments. Peter is a partner with Ernst & Young in New York City. He has been extremely active in internal financial reporting and GAAP conversion activity for a number of years. Most recently, he has been traveling internationally, helping foreign companies convert to a U.S. GAAP basis. With that, I'll turn it over to Steve.

MR. STEPHEN J. PRESTON: I'd like to talk about three different topics. First, I'll talk about the NAIC process and some of the committees that are of interest to life and health actuaries. Then I'll talk a little bit about the American Academy of Actuary committees that support those NAIC groups and some other committees of interest to actuaries. Then I'll turn to the heart of the presentation and give an update on statutory developments, first talking about annuities, then life, and then a brief discussion of health. Finally, I'll discuss some general projects that affect all three of those lines. As Bud mentioned, this is a fairly brief overview. I'll be reviewing quite a few topics, and most of these will be discussed in other sessions.

Probably the most significant NAIC committee of concern to actuaries is the Life and Health Actuarial Task Force (LHATF). This group deals with a wide array of actuarial matters, including nonforfeiture, reserving, and asset adequacy testing. It is supported by two working groups. One is the Innovative Products Group, which deals with issues of an actuarial nature relating to new products such as equity-indexed annuities (EIA) and variable annuities with guaranteed living benefits (GLB). The second is Accident and Health Working Group, which focuses on health issues. There is also the Risk-Based Capital Task Force that focuses on life and health insurance issues. There is an Accounting Practices and Procedures Task Force that focuses on codification accounting issues, such as emerging accounting, and separate account issues. There is also a Valuation of Securities Task Force that deals with various issues relating to invested assets, such as the asset valuation reserve (AVR), interest maintenance reserve (IMR), and securities valuation office issues. There is a Life Disclosure Working Group that deals with illustrations, actuarial supportability, and other disclosure issues. Finally, there is a joint committee dealing with Academy, NAIC, Actuarial Standards Board (ASB), and Actuarial Board for Counseling and Discipline (ABCD) issues.

There are essentially five major Academy committees that warrant comment here. The first, the Life Practice Council, comprises four different committees. The first is the Committee of State Life Insurance Issues. It acts primarily as a liaison between the Academy and the NAIC. The other three groups are the Committee of Federal Life Insurance Issues, the Committee of Life Insurance Financial Reporting, and finally, the Life Risk-Based Capital Group. There are ten committees underneath the Health Practice Council. They deal with areas such as risk-based capital, long-term care, and state and federal health issues. There are five pension committees under the Pension Practice Council, dealing with pension accounting, social insurance and other issues of concern to pension actuaries. There are five major committees on the Financial Reporting Council. The committee that you'll hear most about at this meeting is the Valuation Task Force working on the unified valuation system. You'll also hear about a Joint Risk-Based Capital Task Force and an International Accounting Task Force. Finally, the Council on Professionalism has seven subgroups dealing with professionalism, professional conduct, qualifications and similar professionalism issues.

Regarding the NAIC process, there are quarterly NAIC meetings and many different ad hoc meetings and conference calls. It's important to know that most NAIC meetings are open to the public. There are also NAIC minutes and reports readily available. Probably the two documents of most interest to actuaries are the NAIC Life and Health Actuarial Task Force monthly minutes. Also, many NAIC reports are published on the NAIC.org website. Academy committees to support those NAIC endeavors are typically formed by setting up work groups. Those work groups are also open to Academy members and participation in these groups, together with feedback on the reports that the Academy puts forth is encouraged. If you'd like to get copies of those reports, they can be obtained by calling the Academy.

Moving on to annuity developments, the first topic of discussion is Actuarial Guidelines 33, 34 and 35. These three guidelines all require an integrated Commissioners Annuity Reserve Valuation Method (CARVM) approach for their associated products. Guideline 33 focuses on annuities in general, Guideline 34 focuses on variable annuity minimum guaranteed death benefits, and Guideline 35 focuses on reserving for equity-indexed annuities. The guidelines were adopted in 1998 and are retroactively effective through year-end 1998. There is also a phase-in period that's possible. In general, companies are continuing to be challenged in implementing these guidelines, including dealing with run time issues due to the complexity of the guideline, and programming challenges due to all the options that must be considered. There are four Actuarial Guideline follow-up sessions: 2, 15, 18 and 22.

On a related topic, the state of New York recently released its draft Regulation 151 covering reserving on annuities. That regulation is a requirement similar to Guidelines 33 and 34, and also provides for variable annuity reserving requirements. In most other respects, the requirements are similar to the ones that were in the old Regulation 126. Adoption is possible, but not likely by the end of 1999. However, there is a December 31, 1999 effective date, and my understanding is the state will require compliance, even if it doesn't get formally signed by the governor. This will be discussed in further detail in Sessions 2 and 15.

There were two annuity separate account models that were adopted in 1999. The first is the guaranteed group model regulation covering guaranteed benefits on group separate accounts. It has a similar structure to New York Regulation 128 and California 95-8. It puts forth requirements for plans of operation, reserving requirements, asset maintenance requirements (including a so-called haircut process), and requirements for a separate actuarial opinion. There is a synthetic GIC model that provides, for essentially the same type of requirements as the guaranteed group model. Both models were adopted by the NAIC in March, and there will be further discussion on these models in Session 2.

A new innovative product, variable annuities with guaranteed living benefits, has been receiving quite a bit of attention at the NAIC's LHATF. The Academy was asked to work with LHATF to come up with recommendations, and it has been providing quarterly reports. They've been addressing product development and reinsurance issues, but their primary goal is to develop valuation proposals specifically relating to reserves. The group has been considering the so-called Keel method, which is a single scenario integrated CRVM approach. The group has completed a great deal of testing of the Keel method, and it does work well for some products but doesn't work for others. There will be three follow-up sessions that talk about VAGLBs further.

Products with rating downgrades is another area receiving a tremendous amount of attention at the NAIC. This includes GICs, funding agreements, corporate-owned life insurance (COLI) and business-owned life insurance (BOLI) products, and any other products that provide for book-value surrenders or waiver of surrender charge upon credit rating downgrade. There are essentially two major issues that are currently being addressed by the NAIC. The first relates to concerns that regulators have. In the event of a downgrade, there are potential liquidity and solvency issues, given that this risk may be difficult to diversify. Regulators are concerned that large, sophisticated buyers (who typically drive this business), in the event of an insolvency would be in the front of the line and get their money out prior to the rest of the company's policyowners. The Life and Health Actuarial Task Force sent a fact sheet to the commissioners apprising them of LHATF's concerns relating to these products. The second major area of concern, reserves for these products, is being addressed by an Academy work group. The major conclusion that the Academy group has reached is that this is more of a liquidity or risk management problem than a reserving problem. Nonetheless, they have come up with a series of reserving possibilities. Some of those possibilities relate to the valuation interest rate of plan type, and whether or not the benefits are elective or nonelective. This discussion will continue in Sessions 2 and 37.

The first life insurance issue I'd like to discuss is the Adoption of Revised Regulation XXX. After an absolutely intent effort by both industry and regulators, the NAIC adopted the revised XXX in March 1999. In general, XXX follows the segmental approach that was in the 1995 model, but there were a number of changes to the 1995 model. The first was to improve mortality select factors; the second was reliance on the appointed actuary in determining the so-called "X" factor, which is a factor applied to establish the mortality basis for deficiency reserves. At this time, it appears that there are about 25 states likely to adopt by 2000; about 12 others are under review. It would appear that, by the end of 1999, we'll probably see somewhere around 30 states adopting XXX, although the number of states is changing regularly. This topic will be discussed at five different follow-up sessions in more detail.

Draft Guideline ZZZZ applies the Commissioners Reserve Valuation Method (CRVM) to equity-indexed universal life products. The guideline proposes two alternative reserving methods: Type 1, the so-called implied guaranteed rate method, is a book-value-type approach; and Type 2, CRVM with updated market values, is a market value type approach. This guideline was adopted at the June 1999 NAIC meeting by LHATF but the full NAIC adoption may be delayed until 2000. The guideline is retroactive, it has no phase-in, and it would be effective December 31, 1999. In addition to these requirements, there have been Academy recommendations to be discussed at the next NAIC meeting, including whether a third methodology, the so-called type 2-A method (which is CRVM with updated average market values), should be added to the guideline. Sessions 2 and 22 will address ZZZZ.

At the March 1999 NAIC meeting, the Academy was asked to clarify areas of ambiguity on variable life and variable UL guaranteed minimum death benefit reserves. Presently there are two different NAIC models, resulting in different applications for reserving. Specifically, there is the 1983 Variable Life Model Regulation and the 1989 model. Some states have adopted the 1983 model and others have adopted the 1989 model. Some have adopted neither model resulting in lack of uniformity. Additionally, the recent revisions to XXX relating to secondary guarantees has spawned some interest in this area. As a result, the Academy set up a work group, and have drafted a reserve guideline that will be released for the first time next week at the NAIC meeting. That guideline interprets the Standard Valuation Law based on the 1989 model rather than the 1983 model. It was believed that the 1989 model did not anticipate some of the innovative designs that have been introduced since then. The proposal would require the greater of a one-year term reserve (with an immediate one-third drop in account value) and an attained-age level reserve. The proposal guideline clarifies these two items and clarifies the projection assumptions used in those calculations. This will be discussed in more detail in Session 2.

Let's move on to the health reserve guidance manual. This is an area that has also received a great deal of attention by both the Academy and the NAIC. It will be used by companies to establish reserves, and it will act as a regulatory audit tool. Some of the issues addressed are contract reserves, claim reserves, deficiency reserves, and provider liability reserves. There are five different follow-up sessions to discuss different areas of the guidance manual: 5, 30, 42, 48 and 49.

Let's move on to the proposed revisions to the Actuarial Opinion and Memorandum Regulation (AOMR). This is an area in which there has been a great deal of controversy for the last several years; hopefully some of the recent developments will break this log jam. The direction at this point would be that for Section 8 companies, the commissioner could provide any of three alternatives to the state of filing requirement and utilize a state of domicile alternative. The three alternatives are at the discretion of the commissioner, not the company.

The first alternative is that the company could meet the commissioner's written requirements in order to utilize a state of domicile alternative. Secondly, the commissioner could approve individual companies for state of domicile treatment. Third, the commissioner could require a comparison between reserves actually held and codified reserves. Also the AOMR draft has a new requirement for a Regulatory Asset Adequacy Issue Summary, better known as the executive summary. That document would be provided with the actuarial memorandum for Section 8 companies. In addition, there are other AOMR changes that are being proposed. First, it includes modifications to the Section 7 eligibility tests, and second, it requires a gross premium valuation for Section 7 companies. At this point, the draft requires that a gross premium valuation had margins for adverse deviations, but further discussion will continue in this area. Finally, there are three related Actuarial Statements of Opinion (ASOPs) that are also being revised. These topics are discussed in more detail in Sessions 2, 18 and 37.

Moving on to risk-based capital, the most significant NAIC project has been to replace the existing C-3 requirements with a more dynamic approach, and this project has been underway for three years. The Academy RBC Task Force reached the conclusion that C-3 risk should reflect general asset/liability risk, as opposed to only interest rate risk. The Academy group has proposed that the C-3 interim requirement vary for annuities and single premium life versus other products. The C-3 factor would be based on a weighted average of a subset of stochastic interest rate path results. Those paths would approximate a C-3 factor to reach the 95th percentile. Under this method, you would essentially use a cash-flow-testing model approach. So if you're performing asset adequacy testing, for example, you could utilize the models for the C-3 calculations. The current proposal for other products is to retain the existing C-3 factors. In addition to those requirements, there would be an additional C-3 component required for callable assets supporting untested products and surplus. In addition, the C-3 component under the new approach is subject to a 50% floor and a 200% maximum of the current C-3 factors. The proposal has an effective date of December 31, 2000 (although it is possible that the date could be delayed) and does not deal with equity risks, which will be addressed in the future. There are three follow-up sessions — 18, 24, and 31 — that address C-3 in more detail.

In addition to the C-3 project, several other RBC initiatives were addressed this year. First, RBC factors under development for long-term disability, long-term care, and stop-loss by the Academy will be presented toward the end of the year to the NAIC. In the meantime, there were interim requirements adopted this year, and those will be discussed at Session 12. In addition, there were variable annuity guaranteed living benefit interim C-3 requirements adopted, and modified coinsurance treatment for RBC was also adopted this year. There will be a brief summary of some of those developments in Session 8.

The Unified Valuation System (UVS) project is another project that has consumed a significant amount of resources at the Academy. The project started with a "blank sheet of paper" back in early 1997, implying that a fresh look at valuation would be considered as an alternative to formula reserves. As a result, the current proposals rely less on formula reserves and much more on actuarial judgment and stochastic modeling.

The general principle of UVS is the so-called S-curve approach meaning that stochastic cash-flow testing results are ranked at various percentiles, and then those results to measure the three objectives of UVS are solvency, income, and viability. Each of the three objectives would likely have different adequacy percentiles. The solvency objective measures adequacy of resources relative to obligations. It is currently being proposed by the Academy that the S-curve approach at about the 95th percentile be used, and that approach would replace the existing risk-based capital structure. For measurement of income, addressing changes in resources relative to obligations, the current recommendation is to continue using existing formula reserves, and possibly use the S-curve approach at the 80th or 85th percentile for innovative products that do not fit well into the existing formula reserve requirements. The third objective, viability, measures the ability to execute various business alternatives. In general, this objective would require a viability report to be provided by the actuary, which is similar to the existing dynamic financial condition analysis reports. This viability report would have to reflect both existing and future new business estimates.

There are some other UVS issues that are being addressed by the Academy. There is a numerical examples subgroup, which is testing specific product lines to see how the S-curve would work in practice. The Academy is proposing a reviewing actuary concept, with an additional actuary that would review the appointed actuary’s work to determine compliance with certain prescribed standards and practices. There’s also a subgroup addressing low frequency and high-impact risks that don’t fit particularly well within the S-curve approach. Additionally, the NAIC has asked the Society of Actuaries to complete a considerable amount of research, and build tools that would be needed to support the complex nature of UVS. There have also been drafts of the Standard Valuation Law and the AOMR regulation, although a considerable amount of work remains to be done in that area. There will be three sessions that will talk about UVS in more detail.

Codification is another project receiving significant attention at the NAIC. The effective date is January 1, 2001, although it’s not clear how the state adoption process will go. It does appear that, at this point, the states are likely to implement on the effective date. That doesn’t mean each site adopt the same package, but it is looking good at this point. At the NAIC, there is considerable work underway to implement codification. In fact, there are very few groups that are not dealing with codification issues. Codification will have some impact on valuation actuaries. For contracts issued prior to January 1, 2001, the domiciliarity state rules apply, but for contracts issued after that date, there would be disclosures that are required for domiciliarity state variations from the codified rules. That would require

quantification of the impact both
on the income and surplus of those differences. This will be talked about in more detail in Session 2.

Regarding nonforfeiture, there has been quite a bit of work completed over the last several months in order to try to resurrect a project that was previously in limbo. There is a proposal that is currently being discussed. Like the previous proposal, it would require a plan, and a plan summary be provided to the consumer. The overall design would encourage innovative product designs and product flexibility including some ability to combine life, health and annuity benefits in one platform. There would be some level of minimum benefits required, although less than what is currently required under the existing law. The thrust of the method would be that any company actions would need to be actuarially justified and supported. There would be an annual review by a certifying actuary, and there would also be a reviewing actuary concept similar to what's being proposed for UVS, where the reviewing actuary would need to review the certifying actuary's work to assure compliance with the actuarial principles. Finally, there's a general goal to integrate nonforfeiture with nonguaranteed elements, illustrations, and reserves.

Other developments on nonforfeiture and disclosure include draft Guideline NF ZZZ, which deals with nonforfeiture for equity-indexed annuities. Another draft guideline, XYZ, deals with nonforfeiture for universal life with secondary guarantees. There was also an annuity disclosure model that was adopted last year, and there is work underway on an NAIC life disclosure model. In addition, New York has required that any product filings be accompanied with a supportability demonstration. New York will be developing more specific requirements sometime early next year.

Let's move on to new valuation tables, the Annuity 2000 and the Group Annuity Reserving (GAR) 1994 tables, adopted by the NAIC. At this point it appears that there are about 25 states likely to adopt effective January 1, 2000 or earlier, and there are 10 or so other states also considering it. Also, the NAIC had requested the 1980 CSO replacement table a while back.
Progress has been moving along, albeit perhaps not as quickly as the NAIC would like. There is hope that a basic table will be available sometime toward the end of 1999 or early in 2000, with a full valuation table being generated by the end of 2000.

There has also been an interim short-term individual disability proposed by the Society, and the NAIC is currently reviewing the proposal. On the group side, there is a project underway by the Society to replace the current group disability table, and there is hope that something will be completed by the middle of 2000, but more work needs to be completed before a date can be committed to.

Another project that is under discussion at the Life and Health Actuarial Task Force is whether to permit valuation using substandard mortality on annuities other than structured settlement annuities. This will be discussed at upcoming NAIC meetings and further sessions.

Finally, I'll close with a comment on actuarial practice notes. It's my understanding that at session two, Donna Claire will be handing out life practice note updates. That will include an equity-indexed annuities note, a variable note, a couple of notes on demutualization and an updated life illustration note. In addition, there has been some work underway on revisions to most of the health practice notes. Availability of those is expected by sometime in early 2000.

MR. FRIEDSTAT: Last year, because of all the statutory developments and the adoption of actuarial guidelines, I gave an off-the-cuff presentation on how these NAIC developments would affect tax reserving. During the past year, we found that there have been numerous questions from a tax point of view. How do these actuarial guidelines apply for tax purposes? How do these new tables apply? We decided to formalize this session. I'll be speaking about the tax implications of some of these recent NAIC developments that Steve just talked about. The organization of my presentation will be as such.

At the beginning, I'll talk a little bit about certain basic tax reserve rules relating to the prescribed reserve methods, tables and interest rates. Following that I'll give some discussion of what is involved with Section 807(f) changes in reserve method. While it's true that each company will have its own particular circumstances, hopefully this will give you some background and will give you questions to ask in relation to your company's particular approach to implementing these actuarial guidelines from a tax point of view. I'll then talk about the tax implications of some of the recent actuarial guidelines and Regulation XXX, some of the new tables, and certain ongoing and future developments. I will discuss some of the guidelines and the new tables that Steve talked about that are in the process of being developed, and the future course and direction of the applicable federal interest rate that is very significant from a tax point of view.

Section 807(d) is the section of the Internal Revenue Code that gives you the rules for the prescribed methods, interest rates, and tables. The federally prescribed methods for tax purposes are the CRVM approach for life insurance and the CARVM approach for annuities that are in effect at the date the contract is issued. Notice that there is no 26-state requirement for the prescribed tax reserve method, it's the only applicable method prescribed by the NAIC. For example, in 1995 when Regulation XXX was adopted by the NAIC, that became the prevailing method for tax purposes, even though XXX might not have been adopted in any of the states. If a contract isn't covered by CRVM or CARVM, you're supposed to use the method that's prescribed by the NAIC. For example, the CRVM UL model law and Actuarial Guideline 35 dealing with equity-indexed annuities are not covered specifically within the Standard Valuation Law. Therefore, you must use the method that's prescribed by the NAIC. If there is no prescribed NAIC method, you must use a method that's consistent with the prescribed methods and is most appropriate for the contract. For example, when the various committees were developing the actuarial guideline dealing with equity-indexed annuities, even though it hadn't been adopted with the NAIC, one could have taken the position that utilizing that approach even before it was adopted for tax purposes was reasonable. It was certainly consistent with CARVM principles. That was one of the overriding factors in moving towards those approaches.

In contrast, the federally prescribed interest rates and tables have a 26-state rule. In dealing with tables, you must have at least 26 states that have adopted a table for it to be the federally prescribed table for tax purposes. There is a three-year phase-in for these new federally prescribed tables, which is significant and could give rise to certain planning opportunities. For example, let's say that the 26th state adopts the new annuity tables in 1999. The tables become optional federally prescribed tables for 1999 and for the next three years. They are mandatory for tax purposes beginning in 2003. If you're going to adopt the tables for statutory purposes in one year versus another, that may be reason to adopt them for tax purposes in the same year. The new tables generally yield higher reserves, so you might want to adopt them for tax purposes at the earliest opportunity.

The other keypoint about the tax reserve area is that where there is more than one federally prescribed table, you must use the one that generally yields the lowest reserve. For example, there are various versions of the 1980 CSO table that have been adopted by the 26 states. The rule is that for tax purposes, when looking at ordinary life contracts as a whole, on an industry-wide basis, the aggregate table will generally yield the lowest reserve. You must use the aggregate table for your tax reserving for all policies even though for certain products (e.g., for certain term insurance products), the select-and-ultimate version might yield a lower reserve.

The other code section that's significant to understand for tax reserve purposes is Section 807(f), which deals with change in reserve methods. The key thing I want to emphasize here is that there are certain concepts that we're familiar with in dealing with statutory changes in reserve methods in Exhibit 8-A. The approach and the amount might very well differ when we're dealing with tax reserves. The amount of change in reserves will differ if the level of tax reserves differs from the level of statutory reserves. The approach that you take for tax purposes is different and is fairly well defined.

Changes in reserves for tax purposes do not apply to business written in the current year. If you have a change in reserve method in 1999, 1999 issues are not part of that change in reserve method. The current year's issues are assumed to be on the new basis from day one. The other thing that's significantly different and gives rise to many questions and certainly some tax planning opportunities is that there is a ten-year spread of the difference between the old and the new tax basis reserves beginning the year after the year of change. Suppose that at the end of 1999, we have something that qualifies as a change in reserve basis for tax purposes. Let's say that the difference is one million dollars and the difference can be either an increase or a decrease in reserves. Regardless of the direction, you treat it the same way. What happens is you calculate the difference between the old and the new basis tax reserves at year-end 1999. There is no effect on your 1999 tax return. You use your old basis reserves for the current year in determining taxable gain from operations. At one second after midnight, on January 1, 2000, you change the tax basis of your reserves, and you go to the new basis of tax reserves as your opening balance. The difference between the old basis reserves at December 31, 1999 and the new basis reserves at January 1, 2000 is spread over ten years beginning in the year 2000.

There are many issues concerning changes in reserve basis that have come up. I just want to identify the questions that you should be asking and that you should consider in this subject area. First, as Steve mentioned, some of these applications are retroactive for statutory purposes; that may or may not be the case for tax purposes. Regardless of whether you have to apply these guidelines retroactively for statutory purposes, the rule is that you're supposed to use the interpretation of CRVM or CARVM that is in place at the date the contract was issued for tax purposes. That's a very key issue. I'll be going through this in a little more detail in terms of how to look at the adoption of Guideline 33.

The other key question is whether the reserve approach or the actuarial guideline regulation is a new method, or is it really a clarification of the existing method? If it's a new method, it would only apply prospectively for new issues. If it's a clarification of an existing method, then it will fall under the Section 807(f) ten-year spread rules. The other item that comes into play when we're talking about changes of reserve method is whether something is a correction of an error or a change in method. Without getting into the tax law in a great deal of detail, if something is deemed to be a correction of an error, you will get that change in reserve immediately, all in one year. As we've talked about, if it's a change in method, there will be a ten-year spread.

Very few things qualify as a correction of an error for tax purposes. In Revenue Ruling 94-74, the IRS coordinated issue papers, and a few private letter rulings have all indicated that to get correction of an error treatment, you must have either a mathematical or a posting error. In some cases, where you have ignored and have not valued a certain benefit associated with the policy, you may qualify for correction at an error treatment. The example that has been given is if you had a disability income contract and forgot to value the cost-of-living adjustment feature. If you found that out and you corrected it the next year, that might be deemed a correction of an error and you would get the entire change all in one year.

One thing that I want to emphasize is that what is deemed a correction of an error is very narrow. What you and I might consider an error, may not be considered an error for tax purposes. If you use the wrong interest rate for a particular year's issues or you happen to use the wrong federally prescribed table, that is not a correction of an error. You still have to go through the same process and determine the amount of the change in method that will be a ten-year spreadable event.

Now that I've given a little bit of background on some relevant tax rules, let me briefly discuss the application of these rules towards the new actuarial guidelines. First, each company's particular facts and circumstances will likely be different in relation to Actuarial Guideline 33. Some companies adopted the 1995 version and the 1998 version had little or no impact. Some companies did not adopt the 1995 version, made no changes at that time and then implemented new valuation systems in 1998. Your particular fact pattern will influence how you deal with these guidelines so it is hard to generalize what is the correct tax approach. In each of these situations you have to ask the question, is this a new method? If so, it will only apply prospectively. If it is considered to be a clarification of an existing method, the 10-year spread rules will apply.

Let's look at Actuarial Guideline 33. When the first version of Actuarial Guideline 33 came into play in 1995, there were differences of opinion in terms of how to look at it. Certain people said that this was clearly a new method. There are parts of that guideline that were not part of common practice prior to 1995. The 93% floor on the reserve where preferential rates apply certainly was not used anywhere in practice. The treatment of consecutive free partial withdrawals and some of the multiple revenue stream approaches were not commonplace. Some people viewed this as a new method and would only have applied it prospectively for tax purposes for 1995 issues going forward; existing business would still be valued under the old
method. Other people said that this 1995 version was only a clarification of CARVM. If that position was taken, you would say that all the key provisions were commonplace, and this only codified what was really existing practice. If that approach was taken, then you must go through the ten-year spread methodology that we talked about. You would, in essence, be changing reserves for all issue years prior to 1995; 1995 issues would already be on the new method.

Actuarial Guideline 34 clarified to a great extent the statutory approaches for reserving for variable annuity contracts, at least those with guaranteed death benefits. There are still some issues outstanding on it, but again, the same approach is taken. We have to ask the question, is this a new method that's only going to apply prospectively, or is this a clarification of what should have been the interpretation of CARVM for variable annuities in prior years? There are still some tax issues that have to be dealt with under the 1959 Tax Act. There was a ruling that these reserves for minimum guaranteed death benefits did not meet the definition of life insurance reserves. I think the way that this new law was written will enhance the industry's efforts to get deductibility for that benefit.

Also, I think the prior ruling was flawed. Basically, it dealt with the artificiality of assuming a one-third drop in fund value in developing the minimum death benefit guarantee reserve. I think that companies will be successful on that position under the new guideline. You still have to deal with the issue of whether the minimum death benefit reserve has to be revalued for tax purposes, and whether there is aggregation between the separate account reserve and the general account reserve in determining the final tax reserve and comparison with the net surrender value.

Equity-indexed annuities and Actuarial Guideline 35. Where there is no prescribed NAIC method, you're supposed to use a method that is consistent with, in this case, CARVM principles. This new guideline was not passed until 1998. However, in 1997 the state of Illinois required compliance with the same principles and with the fairly widespread dissemination of the Equity-Indexed Products Task Force report and the reserving methods described therein. A number of companies might very well have mimicked this approach (especially if it was used for statutory purposes) and used it for tax purposes with a change in the required interest rate.
However, in 1998, it clearly was adopted by the NAIC and became the required tax method for tax purposes.

Regulation XXX. Once the version that was passed in 1995 was adopted by the NAIC, even though it might not have been adopted by any state, it became the federally prescribed method for tax purposes. If this is something that you're not doing, you should look at this. This is a planning opportunity; it basically should produce higher tax reserves. Assuming you're on the unitary approach for statutory purposes, it should produce a level of tax reserves that is capped by your statutory reserve through those intervening years. I want to emphasize that even though there were new select factors in the 1995 version and in the 1999 version, those new select factors do not become a federally prescribed table for tax purposes. You must still use the 1980 CSO aggregate table for your mortality reserves. As a matter of fact, one thing that was very significant in the development of the new Guideline XXX was to make sure, assuming that 26 states would pass the regulation, that this table did not generally produce lower reserves and would not have tax implications on other products. Again, the new method became the federally prescribed method once it was adopted by the NAIC for 1998 issues going forward.

New tables. The ones that are probably closest to being adopted are the new annuity tables. Steve said that there were approximately 25 states that had adopted the new annuity tables, and assuming the 26th state adopts it, those tables become federally prescribed tables. Not only would you be required to use them for statutory purposes, but you're also required to use them for tax purposes, even if your state of domicile is not one of those 26 states, with the three-year phase-in election discussed earlier. I'm sure that the ACLI and the Academy of Actuaries and various newsletters that have been monitoring this will keep us informed in terms of when the 26th state adopts these new tables. The last thing I saw was that 25 states had passed them and a number of states were still considering them. They are likely to be passed by the end of 1999.

In terms of the other actuarial guideline that Steve mentioned, I think that the main thing here is that if you do issue variable annuities with guaranteed living benefits or equity-indexed life insurance, you are going to be faced with the issue of how to evaluate these contracts for statutory purposes, as well as for tax purposes. Until these guidelines are adopted, you have to use a method that's consistent with CRVM or CARVM principles. Once they are adopted, you have to use these approaches. So it's in your interest to monitor these guidelines and adopt them at the earliest possible opportunity. It will give you a basis for your tax reserves, as well as your statutory reserves.

The new CSO table (whether it's going to be the 2002 table or the 2001 table or the 2003 table) will become a federally prescribed table when 26 states have adopted it, subject to the three-year phase-in election. The other thing to keep in mind here is that this will also have a very significant effect on product development. The federally prescribed table for Section 807 purposes is also the table that's used to compute the minimum requirements under Section 7702 in order to meet the definition of life insurance. So this new table will have not only a big effect for valuation purposes, but it will also very likely trigger completely new product portfolios. You'll have to change your programs to make sure that you meet the requirements of Section 7702.

Individual disability tables. Individual noncancellable and guaranteed renewal policies satisfy the definition of *life insurance reserves*. As I mentioned, life insurance reserve tables become federally prescribed, when they've been passed by 26 states. If 26 states do not pass a table, there has been a regulation that's in place for tables to be used where there are no federally prescribed tables. So if 26 states adopt the new table directly or indirectly, maybe through minimum reserve standards, it would become federally prescribed at that point. If not, there would probably have to be some sort of regulation that would prescribe it for tax purposes.

The group disability table is different. Group falls into the tax reserving category of "disability other than in credit." I'm assuming that these are cancellable policies. You must use a table that's consistent with company experience for cancellable disability income. What's going to happen in most cases is that companies will adopt the new table for statutory purposes.

Whatever they do for statutory purposes, it's obviously consistent with your experience or you wouldn't have adopted it. Maybe a company will even modify some termination rates to be more consistent with their own experience. They will then use a similar approach for tax purposes but change to the federally prescribed interest rate.

There is a new credit disability table. One thing I want to bring out is that, because of the way the tax laws are written, that kind of disability table will not be relevant for tax purposes. Right now, there are federally prescribed loss payment patterns that you use for credit disability reserves for tax purposes. You do have an option if you're in the 95th percentile to use your own experience. No company that I know of has found it advantageous to use their own experience. So even though this new table may be developed and may be required at some point in time for statutory purposes, its applicability for tax purposes is open to question.

The last thing I wanted to mention was the applicable federal interest rate (AFIR). Basically the interest rate that you use for tax reserving purposes for life insurance reserves is the greater of the state prevailing rate (which is the rate we're all familiar with — the dynamic valuation interest rates) and the applicable federal interest rate, which is a rate that's published. The latter rate is based on a rolling 60-month average of the federal applicable mid-term rates on mid-term securities. The rate has been hovering around 6.3% for the last few years, and it was 6.3% for 1999 issues. Projecting that rate forward to the end of this year and guessing what it will be for the year 2000, which is based on data through 1999, shows the rate will drop. It will probably be in the neighborhood of 6.08–6.10%. For those of you who are pricing on an after-tax basis and are developing a new ratebook, you may want to consider the applicable federal interest rate in your pricing and profitability analyses. I'll turn the podium over to Peter, and he'll be discussing GAAP-related issues.

MR. J. PETER DURAN: I want to conclude this general session by speaking about some important developments in the area of U.S. GAAP. There's a lot going on both in the insurance realm and elsewhere within GAAP, and there are a lot of bodies involved as you know. I want to talk about four developments that fall under the purview of the FASB directly. I have some news about *FAS 133* and two related topics — the present values concept statement, which is in the process of being finalized, and the FASB's fair value project, which is sort of a natural next step after the present value's concept statement is finalized. In addition, the business combinations or purchase accounting type project has had some very important recent developments. I'll speak about them briefly.

Within the AICPA, there are also a number of important developments as well. There's a new proposed audit and accounting guide that replaces what we used to call the audit guide that was issued in 1972. It's obviously out of date. There are a couple of committees that are active on insurance issues. One is the nontraditional products committee. Tom Campbell of the Hartford Life Insurance Company is the actuarial observer there so we do have actuarial input on that committee. The AICPA has a task force on demutualization accounting, and that work is pretty far along. There has been substantial actuarial involvement there. There's also a growing concern among some members of the insurance companies committee at the AICPA about internal replacements, deferred acquisition cost (DAC) issues, and DAC carryover issues on internal replacements that I'll talk about.

I'm going to end with a discussion of the SEC's project on earnings management or earnings manipulation. It's a topic that the SEC is very concerned about. There are a number of GAAP sessions. There's a general GAAP session, Session 11, and Session 4, which all deal with GAAP earnings emergence. There's Session 29 on accounting for derivatives, GAAP accounting for derivatives in light of *FAS 133* for those who really want to get into it. Session 16 is a panel discussion on fair value, and we'll have one of the FASB project managers on that panel. Finally, Session 22 deals with GAAP issues for mutual companies, and I expect they would at least touch a little bit on the demutualization accounting topics.

Before I get into the actual issues, I want to say something about the AICPA process because it's in the process of changing, and I'm not sure it's all well understood within the actuarial committee. The way things have worked until now is that there is a body within the AICPA called the insurance companies committee that deals with insurance issues: life insurance, health insurance, and property/casualty insurance. They identify issues, like demutualization, and they draft a prospectus as to what the topic is. What issues are to be addressed and approved by the Accounting Standards Executive Committee (AcSEC), which is the highest accounting body within the AICPA. At that point, a task force is formed, and it reports to the insurance companies committee.

The task force is responsible for developing a draft Standard of Practice (SOP), and when it does so, it sends it to the insurance companies committee. After that, the draft SOP is reviewed and possibly amended. There may be some back and forth between the ICC and the task force, but then it goes up to the Accounting Standards Executive Committee (AcSEC), which drafts the final exposure draft (which usually looks very similar to the version it receives, although there might be some significant changes). So then the AcSEC issues the proposed standard of practice, and after the common period, it issues a final standard of practice that might be modified from the exposure draft as appropriate.

There's also a similar process for auditing standards as well for auditors. I'm thinking of the new audit guide that followed this same process. Most audit standards are not really industry specific. Very recently, there have been some significant changes, within the AICPA process. It's not clear how all of this will play out. The last time I checked with people, it wasn't clear how the new process would work, but it was driven by cost consciousness within the AICPA. I'm not sure exactly when this is effective, but they've eliminated all the industry committees, including the insurance companies committee within the AICPA. Obviously, there were a number of insurance specific committees in addition to the insurance companies committee. They'll be forming something called the group of 100. Exactly who's going to be on this group of 100 is not clear to me. The group of 100 would then identify issues and task forces would be formed as now, but basically the step of the industry committee review would be eliminated. A number of people have their misgivings as to how well this will work, but it hasn't been tried.

Now there are a couple of FASB issues. First is *FAS 133*. As you probably know, the effective date of *FAS 133* has been deferred until June 15, 2000. The fiscal year is beginning after June 15, 2000, and that was done by *FAS 137*. The reason is implementation issues surrounding

FAS 133, both in terms of implementation, in terms of what we are supposed to do and how we are going to do it in the time allotted. There is a group that is working under the FASB called the derivative simplementation group. It has identified many, many issues on *FAS 133*. It's an incredibly complicated standard, and, as I say, there will be a whole session on derivative accounting.

Another place you can go for a lot of good information is the FASB's website: FASB.org. A couple of the DIG issues are insurance specific, and I'll just mention them now. They've considered traditional variable annuities with a guaranteed minimum death benefit and concluded that the guaranteed minimum death benefit is not an embedded derivative. In nontraditional variable annuity (as they call it), with what we would call guaranteed accumulation benefits here specifically, any accumulation phase does have an embedded derivative. Equity-indexed life and annuity products have embedded derivatives. Market-value adjusted annuities do have embedded derivatives, but they have concluded that there's no need to buy from the contractor because the embedded derivative is clearly and closely related to the host contract.

The present values concept statement came out earlier this year. The second exposure draft came out earlier this year. I believe the common deadline expired August 31. First, I just want to say that this is a concept statement. There aren't very many of them. I believe there are less than ten. Concept statements are not accounting standards; rather they establish a framework for subsequent standards, and this present value concept statement is going to be laying the ground for fair value.

There was an exposure draft as I said. It was actually the second exposure draft that was issued on March 31. The official name of the document is, "Using Cash-Flow Information and Present Value and Accounting Measurements." What it's really talking about is using present value techniques to defer value. That's really what it's talking about. They talk a lot about fair value. As I say, they adopt what they believe is a marketplace view. In other words, when you're talking about fair value, what you're trying to get at is a market transaction for cash. For example, for liability fair value, which has most but not all of the thorniest issues, they're thinking, how much cash is necessary to settle the liability, or I guess we would say in actuarial terms if we're thinking of a block of liabilities, how much cash does the ceding company need to transfer to the company that's doing the assumption reinsurance. That puts it in sort of insurance actuarial terms. That's the concept, although they certainly don't say it that way.

A couple of the conclusions in the concept statement are that they believe that expected cash flows are more appropriate than a single best estimate for doing present values, which I think virtually every actuary would agree with. Second, they say that using expected cash flows combined with a risk-free discount rate appropriately captures the risk in the financial instrument whose fair value we're trying to determine. I was actually involved with the Academy's comment letter on the concept statement, and so was Ed Robbins. We sort of disagreed with the concept that somehow there had to be some provision for adverse deviation, possibly in the discount rate or the cash flows themselves, beyond just using expected cash flows.

Another conclusion with which I think a vast majority of actuaries disagrees is that when doing liability fair value, one should always reflect the credit quality of the issuing company. So if we're trying to do the fair value of a block of insurance contracts viewed as liabilities, the credit worthiness of the issuing company would affect that calculation regardless of the fact that it's an absolute obligation of the company. Of course the lower the credit rating of the company, the lower its fair value of liabilities, which doesn't seem like a good result from a public policy point of view. Moreover, I don't think there's a lot of evidence to support the fact that when you do assumption reinsurance for thinly traded liabilities, the credit value of the original issuing company comes into play. We said that in the letter.

Fair value. There was a fundamental decision by the FASB back in 1992 that fair value was more appropriate than book value as an accounting basis and that guided *FAS 133*. The FASB has said in *FAS 133* that it believes that fair value is the best measurement approach for financial instruments, and financial instruments broadly defined would certainly include insurance liability, so they're moving in that direction.

Some of the issues they're wrestling with are: how do you appropriately adjust the cash flows for risk and uncertainty; should they be adjusted for the credit rating of the issuing company whether it's issuing a liability or an asset; and what's the appropriate discount rate? They believe that the risk-free rate is the appropriate discount rate. They believe that for long duration insurance contracts, future premiums should be considered in determining the liability as essentially an offset to the liability, which certainly makes sense. For short duration contracts, no premiums beyond the current year should be taken into account.

The fair-value approach for liabilities is a fully prospective approach, so there will be no more DAC in a fair value environment. One of the other things that they've talked about is the possibility that at the date of issue, which is different than current GAAP theory, a profit or loss is possible. That's another very controversial area. The FASB and the international accounting standards bodies are wrestling with fair value and, essentially, these same questions.

There was a draft of a statement published on September 7, 1999 that would be a new standard for business combinations in insurance. We call this Purchase GAAP (P-GAAP), but it applies generally. It's not insurance specific, and it amends the existing guidance, which is found mostly in Actuarial Practice Bulletin (APB) 16 and 17 on purchase accounting. Currently, there are really two accounting methods that are used in connection with a business combination: one is pooling, and the other is purchase accounting. There have been a number of abuses in terms of the use of pooling. The bottom line is they're eliminating pooling as a possible accounting method after the effective date of the new statement. That may drive M&A activity just before the effective date of the new statement. There are also some changes and this will have an effect on insurance companies. There's some changes in goodwill and the rules for goodwill. The amortization is limited to 20 years under the new proposed standard, and it's reviewed for impairment after two years. Currently, 30 years or even 40 years is often used for goodwill amortization. If you have negative goodwill that's in excess of the value of business acquired (VOBA), you would recognize an immediate gain to the extent that it exceeded the VOBA.

AICPA developments give audit and accounting guidance for life and health actuaries. There was an exposure draft that was released in September of 1998, and the draft was approved by AcSEC in March of 1999. It is scheduled for issue in the third quarter of 1999. We don't have much time left in the third quarter of 1999, and I don't believe it has been issued yet. As I mentioned in the introduction, it's going to replace the current audit guide, which is officially called Audits of Stock Life Insurance Companies and goes back to 1972. What this does, at least in theory, is it nearly codifies and brings together existing guidance. It's not supposed to create any new GAAP guidance.

There isn't much new, but what is new is of interest to actuaries. One thing it does is it incorporates the SEC's position on shadow DAC, which had never been laid out by either the AICPA or the FASB. When you have shadow DAC, the adjustments are made to equity, to the DAC balance in equity, and these come about because of unrealized gains in the available-for-sale portfolio of the assets so it codifies that. It defines something called the qualified actuary, which is required for benefit and claims liability and for DAC determinations, both in the development of those balances by the company as well as for the auditor. In other words, when you have an audit of an insurance company, the audit opinion is signed by the audit firm. There's a CPA partner that's in charge, but he must use a qualified actuary to review the actuarial balances.

I think this is quite positive for the actuarial profession because I believe it's the first time in the United States that we've officially been recognized by an accounting standard of some type. However, it's not all good news because they didn't quite get the definition of qualified actuary right, and this has been pointed out too, but I think the profession may bear a little bit of the responsibility. What they did is they took the accountants, went to the instructions for doing the annual statement, and they found the definition of the qualified actuary. It's not the one we'd like, but it's there. A qualified actuary is a member, in good standing, of the Academy of Actuaries or a person who has demonstrated actuarial competence to the supervisor (meaning the insurance commissioner). He or she has to demonstrate competence and experience commensurate with the entity's complexity products and liabilities. This is not bad, but I know the definition that the Academy would have preferred is that the qualified actuary be a member of the Academy. That's a requirement set forth by the Academy. That's the type of definition that's in the SVL.

I'm running out of time, so I'll just hit the high points on the remaining topics. As for the nontraditional long-duration contracts, a task force has been working for some time on an SOP. Some of the issues that they have identified are market-value adjusted annuities, minimum guaranteed death benefits for variable annuities, products with minimum guaranteed account values, equity-indexed products, and synthetic GICs. As an example in the area of VA minimum guaranteed death benefits, one of the questions is, is there a liability required? The practice has been varied on that.

In GAAP, I don't believe most companies have one at the current time, and how would the presence of a liability affect DAC amortization? We're also looking at separate account reporting.

As for sales inducements, they're looking at both back-end and front-end. Bonus interest on deferred annuities, which a lot of companies currently defer as an acquisition cost, is clearly headed in the direction of not being permitted. We'll see what happens there. That would be a change and would have a significant impact on a number of companies. As for persistency bonuses, they want to be consistent with the current practice in most companies and accrue the bonus over a vesting period.

Internal replacements. The practice is now varied because for most internal replacements, there really isn't any specific guidance. The only guidance that's found with respect to DAC on internal replacements is in Practice Bulletin 8. It requires a DAC write-off when a universal-life-type contract replaces a "traditional" contract. In any other situation, you can probably find any other type of practice. They want to try or they're thinking about setting out some rules. The issue is what to do with the existing DAC. There are three possibilities: write it off, continue it subject to recoverability, and continue it only when a new contract is "substantially" similar to the old contract. I don't think they've reached any conclusions yet.

Demutualization is pretty far along. This was put on a fast track by the AICPA because there's so much going on in demutualization. I'm not going to have time to talk about this now, but hopefully it will be discussed at the mutual company GAAP issues session. You might use the SOP 95-1 or *FAS 120* approach. It's combined with what many colloquially call a glide path, which says that when you do your projection at the date of demutualization, essentially that's going to be the pattern and that will come out in future financial reporting periods. If it doesn't, you make it come out that way by means of deferred liability. The basic point of earnings management is that some companies tended to make deliberate mistakes in their GAAP financial statements and justify them on the basis that they were immaterial, or at least that's what the SEC thinks.