
2002 Valuation Actuary Symposium

September 19–20, 2002

Lake Buena Vista, Florida

Session 31TS

Practical Issues Of Implementing The Draft SOP On Nontraditional Long-Duration Contracts

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Summary: This session covers the practical aspects of implementing the draft SOP regarding nontraditional long-duration contracts. Specific items include separate account reporting, valuation of products with multiple account values, valuation of death/other insurance benefit under universal life-type contracts and sales inducements.

MR. ROBERT FRASCA: I'm an actuary with Ernst & Young in Boston, and my copresenter is Carol Salomone who is an actuary with Allianz Life.

There was a session on GAAP Issues, and Scott Wright did a very nice job of outlining all of the issues with respect to the statement of position (SOP). What we'd like to do is go into a little more detail on some of the provisions. We'll give some examples.

The one thing that I want to emphasize is that this is a proposed SOP, so it hasn't been adopted yet. It was exposed for comments on July 31, and the common period ends on October 31. If there's anything that bothers you about it, or if you have issues with respect to practical implementation or the calculations, I'd encourage you to comment on it. With *FAS 133* there was a lot of stuff that happened after the fact because people were caught by surprise. To the extent that people can get up to speed and understand what the implications are ahead of time, I think we'll all be better served.

With that as background, there are three main sections in the proposed SOP; separate accounts, the valuation of liabilities, and sales inducements. I'm going to talk about the separate account piece and the sales inducement piece, and I'm going to leave the tough part, the liabilities piece, for Carol.

Let's discuss separate accounts. The proposed SOP tells you when you have one line fair value treatment for a separate account. It gives you four different criteria that must be passed. First, the separate account has to be legally recognized. Second, it has to be an insulated separate account. Third, the contractholder has to direct the assets. For something like a variable annuity, this is easily passed because the policyholder tells you what funds they want to invest in. This would also cover things like institutional separate accounts where the contractholder is defining an investment policy statement that the investment manager is following. That would still fall into the separate account guidance. Finally, investment performance has to be passed through to the contractholder. What this really means is there can't be any limit outside of fees. There can't be any limit on the rewards that the separate account holder or the contractholder can reap from the separate account.

You can't have a ceiling on returns on the separate account, but you can have a floor. It's a little bit uneven in terms of treatment. If you have a ceiling (for example, a separate account where you're entitled to all earnings up to 13%), then the insurance company retains anything above 13% as an incentive that would not qualify as a separate account. However, you could have a floor. Say the guarantee is a 0% floor. In such a situation, you would account for the floor guarantee as a liability to the general account, but the separate account would still get the separate account treatment.

Seed money is specifically mentioned in the proposed SOP. Essentially, what it says is you look through the separate account and treat the seed money like it's an investment in the general account. You would value the proportionate share of the separate account as general account money for the insurance company. This would be the case in most situations, where you can have new policyholders or existing policyholders that could transfer money into the separate account.

Then you would have to treat the assets, the seed money that the insurance company has put into a separate account, like assets that must be sold at any potential time. What that means is that if there's an excess of the book-to-market value, then you'd have to recognize impairment immediately on the investment on the separate account.

I have a quick example with respect to this proportionate interest. Let's just say you had a situation where you had, in the general account, a bond, and it had available-for-sale treatment and an amortized cost of \$800. The market value was \$1,000, and you transferred it into a separate account where the insurer's proportionate interest in the separate account is 40%. In that situation, you would take 60% of the gain, or 60% of \$200, and the gain would be \$120. That's essentially the piece of the asset that you "sold" to the other policyholders in the separate account. The remaining 40% would still be reflected as an available-for-sale asset. Any remaining unrealized gain would be realized upon either sale of the asset, or, if more people were contributing to the separate account and your proportionate share went down, then you keep recognizing the gain in proportion.

The treatment of seed money is the part of the SOP that I think the accountants seem to be focusing on the most. I think, from a practical standpoint, it might be very difficult for them to implement.

In terms of what I'll call the actuarial issues, there are four main issues with respect to separate accounts that I'd like to talk about. The first is insulation. The criterion that the separate account has to be insulated is usually not an issue for most separate accounts that you see in the U.S. However, for those of you who have international operations, I'd just suggest that you talk to your legal people about whether or not the separate account is truly insulated. For example, in the U.K. I think some of the unit-linked funds might cause a problem with respect to insulation. Again, I think it's something for the lawyers to kind of decide.

The second is market-value-adjusted fixed accounts. It's quite clear in the proposed SOP that they will not be considered separate accounts.

The separate account GICs that I'm aware of typically have a provision whereby, right before the maturity, there's a guarantee. It might be guaranteed just for two or three months, but there's a guarantee of the interest rate before that final payout. There could be a gain or loss or a difference between the value of the assets and what the contractholder ultimately gets. That would be enough to throw it out of separate account treatment, or at least that's the current reading.

Finally, there are performance-based fees. I mentioned before that there can't be any limit on the upside that the contractholder can get from the separate account after fees. You can think about a typical arrangement in which you would charge 40-basis-point fees on all the assets, and that clearly would be fine. That wouldn't throw you out of separate account treatment. Let's say you had some sort of performance based fee where you are going to charge 40 basis points on assets. However, if there are any earnings for which the separate account has in excess of 20%, you're going to keep 10% for yourself. That would be a performance-based fee, which probably still would be okay for separate account treatment.

Now take it to the extreme. Let's say that your performance-based fee is that any return in excess of 20% on the account goes back to the fund manager. That's really the ceiling because you're preventing the pass-through of the return. Somewhere in between those extremes, there's probably a level at which these performance-based fees would be viewed to be a ceiling on the return in the separate account. It would probably preclude separate account treatment, but it is not clear within the proposed SOP exactly where that dividing line would be.

That's it for separate accounts. Let's talk a little bit about sales inducements. The proposed SOP defines sales inducements as product features that enhance the investment yield to the contractholder. That's the only real definition you'll find of sales inducements in the proposed SOP. It gives three examples of sales inducements: (1) day one bonus, which is just an extra percentage of premium that you credit immediately; (2) enhanced yield, which is something like a bonus interest rate on a fixed annuity or a subsidized dollar-cost averaging rate on a variable annuity; and, (3) persistency bonus.

I wouldn't have thought of a persistency bonus as a sales inducement, but it is covered in the proposed SOP. You won't find it written anywhere, but I think that the writers of the proposed SOP consider persistency bonuses where there is a one-time payment. For example, a contractholder who persists for ten years, is given an extra 2% of account value at that point. Based on the language, it doesn't appear that they were really considering persistency bonuses to be enhanced interest rates. In that scenario, the contractholder who persists for 15 years, might get an extra basis points yield for the rest of the life of the contract. Again, don't take my word for this. This is my interpretation. The types of persistency bonuses that go out in perpetuity don't appear to be covered by the proposed SOP.

So, if you have a sales inducement, what do you do? First, you recognize the liability. The liability you recognize is recognized as it's accrued or credited. For bonus interest or for upfront bonuses, it's just recognized as you credit the bonus to the account value. It's easy. For something like a persistency bonus that's an extra percentage of the account value at some point in the future, you would accrue for it using some reasonable method without taking into account any possibility of surrender charges, lapses, or anything like that. If you're going to give an extra 5% five years from now, you'd probably just add 1% of the account value each year as a liability. There is an analogy to pre-paid interest features on debt instruments and original issue discounts. You're treating these persistency bonuses almost like an extra interest credit that you want to spread over the life of the contract.

You have now established a liability for the sales inducement. That's the first step. You've established this liability without taking any account for lapsation. You have to assume that people are going to stay around forever. Now you go through a series of tests to see whether you can set up an offsetting asset. There are four criteria. (1) You must have a liability for the sales inducement. You can't set up an offsetting asset unless you set up a liability—that's pretty obvious. (2) The inducement has to be identified within the contract at inception. (3) The inducement amounts must be incremental to what the insurer credits on contracts without

inducements. This is important because if you're offering a bonus interest rate, and you don't have another product on which you don't offer a bonus interest rate, then you don't have anything you can use to compare the bonus to the incremental amount. Presumably, you can't set up an asset in that situation. (4) The inducement amounts must result in credits higher than what will be credited after the inducement. Again, this gets at the idea that the persistency bonus does not result in a permanent increase in returns.

So now you have passed the four tests, and you can set up a sales inducement asset. Rather than set up a deferred acquisition cost (DAC) asset, you set up a "sales inducement asset." It's recognized as a separate asset on the balance sheet, though it is deferred and amortized using the same methodologies that you would use for DAC. The gross profit streams would reflect best-estimate assumptions for lapse and all other items, just as they would for DAC.

I have an example. There's a laundry list of product features behind the example, but the only comment that I'll make is that this is a fixed annuity with a persistency bonus of 2% at the end of year four.

Let's take Table 1. I would consider this to be reflective of pre-SOP treatment. You have a gross profit stream before considering the persistency bonus that is fairly flat. Now we're assuming the persistency bonus is just incurred as an expense in year four. There's no prefunding for it. You can see that the estimated gross profit (EGP) stream that you'd use for DAC has a severe loss in year four. DAC is amortized against the EGPs so the DAC has somewhat of a dampening effect. Net income is fairly flat except for year 4 where you have this big loss because that's where you took into account the persistency bonus.

TABLE 1
Sales Inducements
Example 1: No accrual, no deferral

	Year					
	1	2	3	4	5	6
Pre-Bonus EGPs	98	107	112	113	115	115
Persistency Bonus	—	—	—	(198)	—	—
EGP Stream for DAC	98	107	112	(85)	115	115
Deferrable Expenses	(500)	—	—	—	—	—
Change in DAC	445	(64)	(71)	81	(73)	(76)
Net Income	43	43	41	(4)	42	39

Table 2 considers the case where the bonus is deemed a persistency bonus. Under the proposed SOP, you have to accrue for it using some reasonable method. You can see in Table 2 that there is an accrual of 51, 51, 50 and 47. You might ask, why is the accrual going down over time? It looks like we're taking into account lapses. What's happening is that we're accruing for every policy individually, assuming that the policyholder does not lapse. However, when it comes to modeling out the EGP stream, you're going to take into account your expected lapsation just as you would for any other type of product. So we end up with an EGP stream for DAC amortization now that has a little bit lower earnings in those first four years at the expense of that fourth year loss. You amortize the DAC, and you see the net income stream, which is depressed in the first four years not nearly as much as it was in the prior ones. At least you're spreading it out some. Then it increases some in years five and six. I'd say this is probably what most people are doing currently for these types of persistency bonuses. This is what you do under the proposed SOP if you are not allowed to set up the offsetting sales inducement asset.

TABLE 2
Sales Inducements
Example 2: Accrue for bonus, no deferral

	Year					
	1	2	3	4	5	6
Pre-Bonus EGPs	98	107	112	113	115	115
Accrue Bonus	(51)	(51)	(50)	(47)	0	—
EGP Stream for DAC	48	56	62	66	115	115
Deferrable Expenses	(500)	—	—	—	—	—
Change in DAC	484	(23)	(29)	(34)	(74)	(78)
Net Income	32	33	33	33	41	37

Let's move to Table 3. You are accruing for the bonus. Let's say you were able to pass all four of the criteria mentioned earlier, and you can defer and amortize. Let's see what happened. You have the same pre-bonus EGP stream, and you accrue for the bonus again. Now you can defer and amortize the bonus, and you see the effect that it has on the EGP stream for DAC. Now the EGP stream for DAC mirrors the pre-bonus EGP stream. In effect, when you set up a liability and defer and amortize, you take the entire recognition of the bonus and spread it over the expected gross profits of the policy—the expected gross profits prior to considering the bonus. We go down to the next line, which is deferrable expenses and amortize the DAC. You can see the net income stream is quite level with respect to the amount of in-force business, and it mirrors the pre-bonus EGPs much more closely.

TABLE 3
Sales Inducements
Example 3: Accrue for bonus, defer and amortize

	Year					
	1	2	3	4	5	6
Pre-Bonus EGPs	98	107	112	113	115	115
Accrue Bonus	(51)	(51)	(50)	(47)	0	—
Defer/Amortize Bonus	29	29	28	26	(21)	(21)
EGP Stream for DAC	76	84	89	92	94	93
Deferrable Expenses	(500)	—	—	—	—	—
Change in DAC	463	(45)	(51)	(55)	(59)	(61)
Net Income	39	40	39	37	35	32

Table 4 is next. I'm not suggesting that this is something you would want to do, but I'm using it to prove a point. In this example, I've used a crazy method for accruing the bonus. Instead of accruing it ratably over a four-year period, I'm just accruing it over two years and deferring and amortizing. The point here is that you end up with the same bottom line effect as we had in Table 3. As long as you defer and amortize, it doesn't matter how you accrue for the bonus. It doesn't matter how you set up the liability. You're going to end up with the same bottom line result. You have a little bit different geography on the balance sheet, but you'll end up with the same answer. You can see this in the balance sheets.

TABLE 4
Sales Inducements
Example 4: Accrue for bonus, defer and amortize

	Year					
	1	2	3	4	5	6
Pre-Bonus EGPs	98	107	112	113	115	115
Accrue Bonus	(101)	(102)	1	4	0	—
Defer/Amortize Bonus	79	81	(20)	(24)	(21)	(22)
EGP Stream for DAC	75	85	93	93	93	92
Deferrable Expenses	(500)	—	—	—	—	—
Change in DAC	464	(45)	(53)	(56)	(59)	(61)
Net Income	39	40	40	37	35	32

Table 5 compares the first three examples. In the first example, you're not really doing anything with the bonus. All you have is your DAC asset. You don't have anything for the sales inducement liability or asset. In the second example, you can see the establishment of the sales inducement liability, but in year four, it disappears because it then becomes part of the account value. There are no sales inducement assets in that second example. In the third example, you can see the whole laundry list of possible accounting entries. You have a sales inducement liability, and an offsetting sales inducement asset, which is going to run out over the entire EGP stream. You also have a DAC asset contributing to the net result. Compare example three and four. Aside from a little bit of rounding, you can see that the net result is identical, even though I used two very different means of accruing for the liability. The net balance sheet result is the same, though the geography looks quite a bit different.

TABLE 5
Sales Inducements
Comparison of Balance Sheet Items

	Year					
	1	2	3	4	5	6
Example 1						
Sales Induced Liability	0	0	0	0	0	0
Sales Induced Asset	0	0	0	0	0	0
DAC Asset	445	381	311	392	319	243
<i>Net</i>	<i>445</i>	<i>381</i>	<i>311</i>	<i>392</i>	<i>319</i>	<i>243</i>
Example 2						
Sales Induced Liability	51	102	151	0	—	—
Sales Induced Asset	0	0	0	0	0	0
DAC Asset	484	462	433	399	325	247
<i>Net</i>	<i>434</i>	<i>360</i>	<i>281</i>	<i>399</i>	<i>325</i>	<i>247</i>
Example 3						
Sales Induced Liability	51	102	151	0	—	—
Sales Induced Asset	29	57	85	111	90	69
DAC Asset	463	418	368	313	253	192
<i>Net</i>	<i>441</i>	<i>374</i>	<i>301</i>	<i>423</i>	<i>343</i>	<i>260</i>

That's it for the example on sales inducements. The proposed SOP talks about transition rules for sales inducements. It says that if you've been setting up an asset for sales inducements and treating it like most companies have been (as DAC and including it in your DAC balance), what you do at transition is just split out that piece that's associated with sales inducements and report it separately on your balance sheet. You're going to keep the same amount that you had before. You're just going to call it something different now. You're going to call it a sales inducement asset.

If you are amortizing it like DAC prior to adoption of the proposed SOP, then just continue to do that. But if you weren't amortizing it using that method, then you lock in the amount of the sales inducement asset at transition, and you amortize it against projected gross profits going forward or against interest as appropriate. One point that I didn't make clear before is that a sales inducement could be on either a universal life type product or an investment contract. The

amortization method is going to be dependent upon the appropriate method for DAC for that type of contract.

A few practical issues with respect to sales inducements. I mentioned before the comparison with similar contracts. That can be an issue for companies that don't have similar contracts. Let's say that you have a subsidized dollar-cost averaging program on a variable annuity and you're crediting 8% for the first year as the money rolls into the variable funds. Say you don't have a similar unsubsidized account. Maybe it is a six-month duration that's not subsidized. You don't really have something with which you can compare it so you can figure out the incremental amount. As a practical matter, if you had a one-year guaranteed fund, I suppose you could probably compare against that. However, you can see that you have these comparability issues. In fact, if you don't offer any other fixed accounts at all, I think you have a real problem under the proposed SOP in terms of being able to defer and amortize.

The second issue is recoverability and loss recognition. I think it's clear that for recoverability and loss recognition on DAC, you have to consider the sales inducement before you do your recoverability test. The question that is unaddressed in the proposed SOP is whether the sales inducement asset is subject to recoverability and loss recognition testing itself. I think you go back to the rationale for why you were able to defer and amortize in the first place, and that is the analogy to debt instruments. Our current interpretation is that you would not test recoverability or loss recognition on sales inducement assets. The thought is that a sales inducement really is not a deferred acquisition cost. It's something more akin to an interest credit, and, for that reason, there is no loss recognition or recoverability testing done on a sales inducement asset. As for shadow treatment, all the *FAS 115* elements that you would apply for DAC or unearned revenue would apply for sales inducements as well.

The final point I'll make is on policy replacements. There's a proposed SOP coming out on policy replacements. There is wording in it, at least in the last version I saw, that talks about what you do with a sales inducement that is part of a replacement program. I think what it says is that you treat it as if the sales inducement was in place at the issuance of the original contract.

Let's say a contract has been in force for five years, and you go on to replace it with another contract.

Let's also say you paid a 2% bonus on the replacement. You're supposed to pretend that you knew about the bonus when the original contract was issued five years earlier. You're supposed to figure out what your current liability and asset would be today based on the assumption that you anticipated the bonus at issue, which I think can be difficult. That is because, if you're accruing, you'd have to say that you were accruing each of those five years, and that you were already setting up the asset and amortizing it. I think you get into a lot of mechanical complications in that situation. So keep your eyes on the development of the replacement SOP and see how the sales inducement asset might end up being affected.

MS. CAROL F. SALOMONE: I'd like to talk a little bit about how this SOP has come into play and what the motivation for it was. I'd say a lot of it, particularly the valuation of liability piece that I'm going to be talking about, has come about to tie up some loose ends from previous accounting proclamations. The SEC produces accounting standards. When there's a divergence of process, like when the SEC sees different companies applying what they've already put out there in different methods and getting different kinds of results, they'll put out a statement of position to help clarify. The SOP also produces more consistency company to company so that financial statements can be more easily evaluated.

In the interest of clarifying positions in *FAS 60*, *FAS 97* and *FAS 133*, we thought this SOP would help us a little bit. *FAS 97* has a section that talks about account balances. It has an accretion model that I'm sure you're all familiar with. The account balance is just a deposit; net of withdrawal plus credit amounts, less the fees and charges. The credit amounts are at the rate that would accrue to the balance that's available in cash. That wasn't clear in *FAS 97*, so this is a clarification of that. A multiple account balance type of product uses the highest account value that would be available in cash or equivalent when calculating the credited interest rate. There will be no reductions for surrender charges or market-value adjustments. Here's a key point: no liability for annuitization features could be accrued during the accumulation phase.

Another type of contract addressed here is contracts that have a return based on a pool of assets or an index. Let's take types of contracts that are not covered by *FAS 133*. If the return is based on a reference pool of assets, then the account balance needs to be based on the fair value of assets. This is true even if the assets themselves are not being carried at fair value.

Another piece of the valuation of liabilities is annuitization features. First, if market-value-adjusted annuities, as Rob mentioned, don't pass through all the profits, they're not going to meet separate account criteria. If they don't meet that criteria, then the account balance is going to be based on the contractually specified rate, and the market-value adjustment would be just considered as a surrender charge. That would not be considered when calculating the account balance.

Two-tier annuities are specifically addressed, and I'll quote. "An annuitization option is an elective benefit that it is not part of the accumulation phase." If that's the starting point, then the account balance is based on the lower tier. That's the balance that would be available in cash, as we said earlier. I'll have an example of exactly how this all works a bit later.

A third contract type that is addressed is variable contracts with guaranteed minimum income benefits. If the guaranteed minimum income benefit (GMIB) can be net settled (meaning you can cash it out for cash or cash equivalents), then it's considered an embedded derivative, and it goes to *FAS 133* for accounting treatment. The general case is that an income benefit stream is generally paid out over time—not net settled for cash. So more often than not, a GMIB is going to come under this treatment and the liability will be the accrued account balance at any point in time. It's important to understand that these rules are going to change the accounting at transition for the majority of annuitization options that most companies are holding.

Moving to the examples, the payout phase reserve is going to be defined by the valuation rate that implicitly equates the income stream that was promised to the cash value available at annuitization. In other words, that would be the lower tier fund value, which would be available in cash. The income stream that's based off of the upper tier has to be equated to the account value at the lower tier, which is going to cause some interesting results.

First, for a two-tier annuity, assume that the lower cash tier is going to accumulate at 3%. The annuitization tier is currently at 5%. I'm going to do a little income statement, so I need an earned interest rate. Let's just assume 6% all years. For these examples, I'm ignoring DAC. DAC will soften some of the effects that you'll be seeing, but it doesn't really change the dynamics. It's just simpler not to work with that. You see the lower tier accumulates at 3%, and the upper tier at 5%. Let's assume payouts are going to begin after five years and the payout option is a simple five-year period certain annuity. The contract rate to calculate the payout amount is 4%. Then the payout amount for the five-year period certain was calculated using the upper tier value at the end of the fifth year of \$1,276 and a five-year period certain at 4%. We all can do the actual math. It comes out to a \$286 payment.

When you equate the lower-tier account balance (\$1,159) at the end of the fifth year with the payout amount that was calculated using the upper tier (\$286), the interest rate that equates those two is 7.52%. You can see on the income statement, during the accumulation phase, that the net income is the spread between the 6% we're assuming it earned and the 3% being credited to the lower tier reserve. During payout, the net income is also just the differential, but now it's the differential between the 6% you're earning and the 7.52% that you're forced to accrue the liability at going forward. I think most of us, as actuaries, would not be real comfortable with this as an income stream, but this is what is being proposed by the SOP as the appropriate way to do this.

Another very similar example is a GMIB, which works pretty much the same way. Assume the account value was up at the separate account net return. The GMIB roll up interest rate is 5%, so that balance will end up in the same place as the upper tier, the amortization value, and you'll end up calculating the same payout amount. The income statement for the first five years for a variable annuity contract will show that your net income is the mortality and expense (M&E) charges. Then, during the annuitization period, the net income is going to be the difference between the 9.56%, which is the implicit interest rate that would be calculated on this basis. For some reason, I chose a yield rate of 6.5% instead of 6%.

The next topic being covered under the valuation liabilities is a significance test for mortality and morbidity guarantees. Contracts need to be classified as either being insurance or investment. Significance, defined by the SOP, will be determined at contract inception other than as you transition to this new SOP. The significance test basically compares the present value of excess benefit payments to the contractholder assessments or the revenues of the contract. We're guided to look at reasonably possible outcomes. That is verbiage straight from the proposed SOP. It seems to me that they're expecting some sort of stochastic testing to be done, although there's really no specific guidance. It seems like a fair amount is left to company discretion.

Contracts with death or other insurance benefits require an additional liability for insurance contracts once it has been determined that it is an insurance contract when the amount assessed for the insurance features are not proportionate to insurance benefits provided during the period. That is a concept we're all familiar with. If your premium is level and your benefits are not, you need to hold a reserve. The SOP gives a methodology for doing this. They want to recognize a portion of the assessment that compensates the insurer for the benefits that are going to be provided in a future period.

For additional liabilities, there is a formula to calculate it that is being proposed. It is a current benefit ratio times cumulative assessments. Subtract from that cumulative excess payments and related expenses, and then add accreted interest. The benefit ratio is defined pretty clearly in the document. It's determined over the life of the contract, and it is calculated as the present value of the total expected excess insurance payments and expenses divided by the present value of total expected assessments. In calculating these assessment values, we're guided to use the actual company experience from issue to the valuation date when you have actual experience and then expected experience after that.

I have another very simple example. In this contract, the revenues are level over time, and the excess benefits grow over time. Then the benefit ratio would be calculated. There is the 8% present value factor, which is for illustration purposes. That's something that will be determined on a company basis. You calculate the present value of the revenues, the present value of the death benefit, and the ratio of these two is your benefit ratio; 47.4% in this example. A very

simple calculation. The 47.4% is used to determine what amount of the annual assessment should be used in calculating this reserve. Basically, the annual assessment times the benefit ratio is \$569. The liability calculation will be the cumulative assessment times the benefit ratio. You have the yearly annual assessment at \$559, which you just accumulate. You subtract the cumulative excess death benefits and then add accreted interest to get the year-by-year additional liability for the minimum guaranteed death benefit (MGDB) reserve.

Another way of doing this is a kind of a *FAS 60* retrospective method. You take the beginning liability. You add what is considered the net premium, which is the benefit ratio times the assessment. Then subtract the excess death benefits, and add interest to get the end of your liability that will roll up just the way we are all very familiar with from a retrospective reserve methodology.

There are some key points with this. This liability can never be less than zero. We are told that the expected experience is supposed to be based on a range of reasonably possible scenarios. This is different from *FAS 60*. These estimates need to be regularly reevaluated with actual experience. It's a type of dynamic unlocking. These changes in the additional liability would be reported as a charge or credit to the benefit expense. In addition, EGPs need to be adjusted to reflect changes in the MGDB liability, which is going to affect the exact amortization.

As for the SOP, there are four issues, that we'll talk about one by one. They are the MGDB calculation, recognition of earnings, measurement of the liability, and the timing of the SOP as we look at international and national accounting issues going on around it.

First, there are the MGDB concerns. We're given this mortality significance test, but we're not told at what level it becomes significant. That will be a company judgment, which, if the point of this is to promote uniformity in reporting across companies, there is certainly a lot of discretion in what is significant. The benefit ratio definition in various discussions with other actuaries is being questioned as to its appropriateness on how that's being calculated. Are revenues or assessments really the right base? As we all know, there's a lot in revenue that might not be directly related to excess death benefits. So does it make sense for that to be the base? There's a

fair amount of discussion about the test being designed to more accurately be able to set up that reserve. As I said before, this is kind of a *FAS 60* approach with dynamic unlocking, and it is kind of a new concept. I don't know that it is a bad concept, but it's certainly a different way of looking at something.

The SOP, in determining when to recognize a liability, goes back to *FAS 97*, paragraph 7. I'm just going to read that directly because it's pretty important, and much of this SOP relates directly to this. "A contract provision that allows the holder of a long duration contract to purchase an annuity at a guaranteed price on settlement of a contract does not entail a mortality risk until their right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms." This means the accumulation phase of a policy is one contract and the annuitization phase is another contract, and this brings up several questions.

Let's take the example of the two-tier annuity and the GMIB. When can a liability be recognized? I think we will agree, in a GAAP accounting basis, that you don't want positive earnings during the first five years of the contract at the expense of negative earnings at the end of the contract. Therefore, it seems natural that some liability should be set up during the accumulation period, but under this SOP, that's not allowed. So much of this SOP relies on this paragraph. The question is, was it written to cover testing for the presence of mortality risk? I think we all know that it was for that, but now it's also being used to state when to report earnings of an economic event. That might be an overuse of this paragraph.

Another question is should a contract be defined differently for accounting purposes than it is for a legal contract? The contract that provides for annuitization options is one contract throughout the entire life of the policy, but for accounting purposes we've determined that it's two policies. I don't know. Is that good? Is that bad? Is that reasonable? Probably the crux of this whole thing is should the annuity benefit cost be recognized only when elected? Because the annuitization is in the control of the policyholder, they're saying that you don't want to recognize it during the accumulation period. However, this treatment does leave you open to the excess annuitization benefits causing negative earnings throughout the annuitization period.

GAAP accounting requires the disclosure of a contingency when there's at least a reasonable probability that a loss might have been incurred and that the loss can be reasonably estimated. The question was, was it intentional to not carry this into *FAS 97*? *FAS 97* is the basis for this SOP. I don't know the answer to the question, but I think it raises some interesting issues. It seems that not all previous accounting literature was reflected.

Can measurement be done? When this SOP was being drafted, there was clearly a divergence of opinion on whether a liability should be accrued for during the accumulation period for annuitization values. Because of that, they're spending a fair amount of time looking at ways that one might be able to measure it. They went through three different methods: one of them is a present value of the cash-flow model, which is something we actuaries certainly do know and understand.

Then they raise questions as to what would be appropriate assumptions with regard to probability of annuitization, discount rates, and other assumptions. In the end, they basically decided that since it would not be easy to set these assumptions consistently company to company, it would be better not to set up a liability.

It's somewhat clear from my comments that I'm not in agreement with the SOP on some of these issues. As actuaries, there is somewhat of an incumbence on us if the accounting profession says, "We don't know how to measure that to be able to help them with the measurement."

So how should it be done? First, there is the probability of an annuitization. Two-tier annuities have been around long enough. Companies that have been writing them have good experience on utilization rates. GMIBs are a newer benefit and, certainly, very sensitive to different economic conditions. It's going to be hard to measure, but I don't know if there needs to be guidance or if it's just one of those things that, over time, would true up; however, they're correct. I think that company to company, if you try to calculate the liability for the GMIB, you probably will have a little bit of divergence as to how exactly it would be calculated. The question is, can we, as actuaries, agree on a reasonable approach here?

Moving to the larger world of current accounting issues, there are just some other questions. Will this SOP conflict with probable additional disclosure requirements stemming from Enron and the like that have been going on over the past year? This SOP has been on the board for two, three, or more years. Certainly, the concepts being presented in it were out there way before the past year's accounting difficulties came up. So one wonders, based on what's going on now, if it's already a little bit outdated.

Another question is, why adopt this now if international accounting standards are going to apply in a year or two, which would probably replace a lot of the current GAAP provisions anyway? To implement a lot of these issues is going to take a fair amount of actuarial and accounting work. I'm not sure that it makes a lot of sense to adopt it for a year or two.

U.S. GAAP is currently a default accounting methodology worldwide. I'm not sure that implications on international products have really been considered.

The IASB and FASB have set recognition as a priority project, and this SOP certainly does clarify the importance of the recognition question.

As Rob said, this is still a proposed SOP. We have to implement many things whether we like them or not. This SOP was initially released at the end of July 2002. We have through the end of October 2002 to get responses back. Responses are being solicited, and I believe we can still impact the final version of the SOP.

As I think Rob alluded to, there are a lot of things in *FAS 133* that I think actuaries missed the boat on. In my opinion, I feel like we all sat there and said, "That doesn't make any sense. I can't do that." But we didn't do anything about it, and it came out in the form that they gave it to us. We're stuck with it. Let's not do that again, okay? I would challenge you to read through the SOP, look at how it applies to your company's products, or even what your competitors are going to be able to do, and determine whether any of that troubles you. If you have issues with it, work with the accountants in your company, and work with your audit firm to put a response together.

I really would like to see a lot of responses to this on the table because I think there are some very clear actuarial issues that we should be addressing. It's difficult to get through the accounting lingo and understand how they want to look at issues. Work with your accountants and your auditors so that it will probably go a little bit easier for you. I would also encourage you not to just say, "I don't like that." If you don't like what's there, give them an alternative. Tell them what would be better.

It's not like some of this guidance isn't needed; I'm not sure that some of the guidance that they're giving is as good as it could be. If there's a way that we, as actuaries, and as an actuarial profession, could help make it better, I think it's our duty to do that. That's the end of my presentation. I think we'll open it to questions.