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Session 11OF
GAAP Issues—General

Moderator: David Lawrence White, Jr.
Panelists: Alastair Longley-Cook
John W. Morris
Gregory M. Smith

Summary: The panelists discuss recent Generally Accepted Accounting Principles (GAAP) developments and practical problems in implementing and maintaining GAAP systems under all FASB accounting models. Panelists offer prepared remarks on several of the following topics:

- *Recent GAAP pronouncements*
- *American Institute of Certified Public Accountants (AICPA) insurance companies committee developments—including demutualization, mutual holding companies, nontraditional products, treatment of internal replacements, separate account sales inducements, and other bonus arrangements*
- *Modeling and approximations*
- *Deferred Acquisition Cost (DAC) amortization issues*
- *Recoverability/loss recognition issues*
- *FAS 115 issues related to FAS 60, FAS 97, FAS 120 products*
- *Accounting for derivatives and equity-indexed products*
- *Other uses of GAAP financial information and financial models*

Chart(s) referred to in the text can be found at the end of the manuscript.

MR. DAVID LAWRENCE WHITE: Our first speaker is Alastair Longley-Cook, who is currently Aetna's corporate actuary and corporate compliance officer, as well as chief actuary of Aetna Financial Services. He has worked as an actuary in many areas at Aetna, including life, group, corporate, auto, and homeowners. He has also served as Aetna's director of investor relations. He is the author of several papers on risk management.

Our second speaker is Greg Smith, a consultant in Tillinghast-Towers Perrins' Hartford office. He joined the firm in January of 1998. His practice areas include product development and design, financial reporting, including development of statutory and U.S. GAAP. During his tenure at Tillinghast, Greg has assisted insurers in Germany, Switzerland, the U.K., Australia and Panama with conversions to U.S. GAAP financial reporting. In addition, he has worked with a number of U.S. companies in preparing historic and purchase GAAP financial statements and in GAAP practice reviews. Prior to joining Tillinghast, Greg worked in CIGNA's corporate-owned life insurance pricing unit. In addition, he worked in the company's pension, health care and reinsurance divisions.

Our third speaker is John Morris, who is a consulting actuary in the Valley Forge office of PricewaterhouseCoopers. John has been involved recently in several demutualization and global GAAPing projects. John is currently a member of the Academy of Actuaries' Committee on Life Insurance Financial Reporting. He's also the Academy's representative on the AICPA's Deferred Acquisition Cost (DAC) on Internal Replacements Task Force.

MR. ALASTAIR LONGLEY-COOK: I'm going to talk about a solution that we developed at Aetna Financial Services for a problem that I think has plagued a lot of us for some time, and that is how to deal with the unlocking of DAC in variable annuity products. I want to talk a little bit about the current practices and some of the problems and issues with them. I'll describe what we call the stochastic DAC unlocking model and talk a bit about the implementation issues and their implications.

I'm referring to deferred annuity products subject to *FAS 97* that have a significant variable fund. These are subject to *FAS 97* deferral of acquisition expenses. The DAC balance is established and then adjusted periodically to recognize the actual margins earned and any changes in projected margins.

The normal calculation that one would do in the unlocking process is fairly intense in terms of capturing the data and running the historic and projected margins and calculating an amortization ratio. Then, as you update the DAC balance periodically, you would calculate the current balance by looking at what the new future margins are and multiplying by your new amortization ratio. The change in the DAC flows through earnings with a positive catch-up being a contribution to GAAP earnings. Those numbers can be significant. When you think about how large your DAC balance is, if you have a significant catch-up, that amount flowing through earnings can have a material impact in a reporting period.

Many companies do their unlocking annually because of all the work involved, and, in the past, many companies have spread the effect equally over the coming four quarters. There are reasons why that is not generally accepted practice today. The current approach is that if you have a catch-up, you've got to recognize it immediately. Another approach would be to have a quarterly unlocking but maybe freeze the amortization ratio on an annual basis.

There are several limitations to the current practices that we try to address in our approach. The biggest one is the volatility in the actual and future margins caused by volatility in the equity returns. If you're looking at mortality, expenses, interest rates, or persistency, those tend not to fluctuate very widely. The adjustments to the actual and future margin assumptions are not that great. The unlocking tends to be limited. However, in variable annuities, the future profit stream is highly dependent upon and perhaps entirely composed of the fees earned off the account balances. Let's say the amount balance is entirely in the equity market. The equity market might plunge by 20% or more in a quarter. You're going to have wide swings in future profit margins and, therefore, wide swings in the DAC balance.

The current practice of doing one deterministic run doesn't deal with that very well. There are some adjustment techniques that companies are probably using or that we and others have used

in the past. These techniques would involve assuming, in your deterministic run, that there is going to be a market correction so that when one occurs, you don't have an enormous change in your DAC. Or, you can use a conservative future growth assumption in terms of the earnings on the equities.

I think you might run into problems with *FAS 97* if you use those approaches. I've certainly always felt a bit uncomfortable about that. If you read *FAS 97*, Paragraph 23, it states that estimated gross profits shall be determined based on the best estimate of that individual element. It specifically says, "without provision for adverse deviation." Is that assumed correction or that conservative future growth assumption a provision for adverse deviation? Perhaps those approaches could be challenged on that basis.

There are some other changes in the regulatory environment that affect current practice. The SEC has become increasingly focused on management of earnings and use of a materiality safe harbor that companies might have been relying on up to now to use to justify the practices that they've been using. There is a famous decision on management of earnings. You can look up the W.R. Grace decision regarding use of reserves to manage earnings at the Website: www.sec.gov/enforce/adminact/34-41578.htm. The SEC took significant objection to the use of so-called "cookie jar reserves." I don't think we consider actuarial reserves as cookie jar reserves to the extent that they can move up and down based on very judgmental assumptions. Somebody might make a case that they could be used in that way.

Materiality is the other issue. In the past, the rule of thumb has been, if it's less than x percent of earnings, then it's immaterial. Even though you're spreading it out over four quarters, it doesn't really matter. That is not considered a valid justification, and the SEC Staff Accounting Bulletin 99 at www.sec.gov/rules/acctreps/sab99.htm can give you some additional guidance. With both of those issues in mind, it occurred to us that we needed to come up with a new approach.

Projected variable margins are generated stochastically in the stochastic DAC unlocking model that we developed. The others are deterministic. We use an equity model to generate equity

returns and calculate a whole series of different future market growth scenarios. Those then generate a distribution of present value of future margins.

With this distribution of results, we can then decide on a corridor within that distribution. If the DAC is in that corridor, we just leave it alone. There is no positive or negative catch-up. We've set that corridor between the 15th and the 30th percentile on the left side of the mean. If the DAC falls below that corridor, we have a positive catch-up, and if it's on the other side, we have a negative catch-up.

Chart 1 shows a made-up illustration in which the corridor is a half a standard deviation to one standard deviation away from the mean. The arrow indicates where our trued-up DAC is. If it's in the corridor, there is no adjustment, and no change.

On the other hand, if the DAC is below the corridor (as in Chart 2, then we true it up by bringing it to the edge of the corridor). So the difference between where the arrow was and where the arrow ends up, would be the amount of the catch-up. Similarly, if we're on the other side, then we would move it to the edge of the corridor. That would be the amount of the catch-up. This would be a negative catch-up.

I don't want to spend a lot of time on the implementation issues. You do need to create the probability distribution. We use normal distributions. You could use something more sophisticated like a stable Paretian to get fatter tails. We do use some mean reversion, which helps make that a very realistic distribution. We factor in the fixed-income percentage. You do need to have some dynamic lapse assumptions in the model to make it realistic. Those are assumptions that a lot of us aren't totally comfortable with. How will people behave as these markets go up and down with regard to transferring funds in and out of fixed versus variable accounts?

We have used the prior quarter's data rather than trying to do it all immediately at that quarter. We're really looking at the last quarter's results, but you're within one quarter of what's going on. That's a reasonably short period of time. We freeze the amortization ratio (AR) as of the

year-end so we're not changing that midstream. Then you can allocate that by block of business either by doing it directly or by using some allocation tool.

This is something your outside auditor needs to agree to. You clearly can't have a black box that nobody understands. It needs to be transparent enough for them to understand what's going on inside. Building off the baseline, the deterministic approach in the valuation system helps ground it. Proper documentation, of course, goes without saying.

The determination of the corridor boundaries need to be reasonable. We believe the one-half to one standard deviation is a reasonable adjustment. This is consistent with a fair-value accounting type of calculation. When somebody pays in the market for something with an uncertain outcome, they don't pay the expected value. There is a discount for the uncertainty involved; this corridor is a good representation of what that might be.

In conclusion, what are the implications for GAAP financials? You have a corridor reducing the volatility of a DAC catch-up for any short period market swings. You avoid the perception that you're managing the result by coming up with assumptions on future corrections or future conservative growth that gets you the answer you're looking for. We believe one approach is consistent with *FAS 97*. Specifically, in Paragraph 57 they talk about conservatism, and while *FAS 97* says you can't just arbitrarily throw conservatism in, they do mention that when you have two equally likely alternatives, you should pick the more conservative one. One way of looking at our approach is to say the one-half to one standard deviation on one side of the mean is equally possible with a one-half to one standard deviation on the other side. We're picking the more conservative one. I also think that it is consistent with fair-value accounting for the reasons I mentioned. We don't have fair-value accounting yet, but who knows? Maybe we'll have it sooner rather than later, and this would be very consistent with that.

Lastly, I'd like to give credit where credit is due to three actuaries who were unable to be at this meeting. They are Jay Vadiveloo, Dick Shaw, and Mike Sherrill, all from Aetna Financial Services. They made all of this work the way it did. I'll be very interested in your reaction and comments. We do believe this is a practice that we think would help a lot of companies deal with a very difficult problem.

MR. GREGORY M. SMITH: We'll be discussing the ongoing effort to develop an international accounting standard for insurance. I'm excited to talk about this topic. It has been something that I've seen in both of the presentations I've attended. I know that others have given some details. We'll try to drill down on a few key issues, as well as take a look at what the FASB's reaction has been.

As you know by now, the International Accounting Standards Committee (IASC) is an international body of accounting standard setters which counts most professional accounting bodies in the world among its members. The standards are being developed in the hope that they will provide a consistent set of guidelines for investor reporting, and the standards, once they're adopted, will not be automatically binding on members. Instead, they will encourage member countries to align their national standards in order to achieve convergence.

We'll take a look at some background on the development of the standards and talk about ten key issues that come straight out of the issue paper released in the fourth quarter of 1999. Then we'll talk briefly about the IASC's thoughts on fair value and things that they considered.

To put the insurance project, as it's called, into context, let's look at the current state of play. There is no current international standard for insurance reporting, and, at first glance, insurance contracts might seem to fit the definition of financial instruments. There are two international standards for financial instruments. Standard 32 concerns the presentation and disclosure, and Standard 39 concerns recognition and measurement. Both of these standards exempt insurance contracts as they're currently written, and, hence, the IASC established the insurance project about three years ago. As it currently stands, the financial instrument standard is largely a reflection of U.S. GAAP methods. This was seen by members of the committee, at least initially, as a compromise, partly to appease banking, and as a stop-gap situation. With that in mind, IAS 39 is under review by a joint working group on financial instruments. This is a group of national standard setters and members of the IASC.

The financial instruments and insurance projects are running side by side, and there is quite a bit of interaction between the two projects. This is important because, ideally, they should be

aiming for a consistent approach to reporting all financial instruments, whether they be insurance or noninsurance.

The scope of the insurance project is ambitious, and a number of parties, in addition to the IASC, are playing an important role in developing the standards. The driving force behind them is the International Organization of Security Commissions. This represents stock exchanges from around the world. Their concern is the difficulty that companies are currently having when they want to list in another country or when they wish to raise capital in another country.

The International Actuarial Association is also an important participant in the effort, and it is represented on the Project Committee as an observer. Having actuaries involved has allowed us to have influence in the development of the standards.

In terms of the timetable, we are relatively early on in the process. In May of 2000, the comment period on the issues paper was closed, and the next steps noted in the issue paper say that there will be a development period for an exposure draft that could last over 2000 and 2001. With that in mind, it's possible that we won't see a standard until fairly late in 2002. However, as I mentioned before, now is the time to try to influence the direction of the standard-setting process.

Insurance accounting is not intended to cover all aspects of accounting for insurance; instead, its focus is strictly on insurance contracts. Other aspects will be covered by other standards, and, it's assumed that financial instruments held by insurers (such as financial assets and liabilities), will be covered by the financial instrument standard that is currently being developed. However, it's important to keep the accounting for insurance contracts consistent with the accounting for other financial instruments. The assumption currently being used by the Financial Instruments Working Group is that fair value is the appropriate way to go; that's also the operating assumption for the insurance project.

While there isn't to be a single standard for all insurance contracts, the IASC does envision separate accounting models for life insurance versus general insurance or, as we would probably identify it, property and casualty insurance. However, at this stage, they've not indicated how these models might differ.

Let's discuss definitions. At present all of the definitions are tentative, and each of them have some problem areas, vague words or undefined terms, and that, undoubtedly will lead to some interpretation issues and could possibly even create undesirable accounting arbitrage opportunities. For example, the proposed definition of insurance contracts currently excludes pure investment business and derivatives, but seems to include gambling. In addition, the tentative life insurance definition could disqualify all nonguaranteed premium rate business. We hope that the time spent parsing the definitions will be moot because, if we can develop a consistent accounting framework that applies to all financial instruments, then the lines of demarcation will be less important. In their comments on the issue paper, the FASB pointed out several flaws and gray areas in the definitions and suggested that additional refinements will be needed in the next document.

Next we'll discuss ten key issues that were considered by the insurance project Steering Committee. You can get a copy of FASB's comments to the Steering Committee on the Internet at www.fasb.org. Issue One. Two accounting models were considered in deciding how to create a overall objective for accounting for insurance contracts: the deferral and matching view and the asset/liability view. We recognize the deferral and matching as the accounting paradigm that underlies important U.S. GAAP pronouncements like *FAS 97*. The deferral and matching view also underlies the margin on services accounting approach in Australia. The approach also seeks to match revenues and expenses, which, in turn, leads to a desired pattern of profits. On the other hand, the asset/liability view focuses on the measure of assets and liabilities. Income under this view is the difference between balance sheets. The results could be quite volatile, and this accounting approach could be in conflict with the current paradigm that some accountants and investors are used to in other countries. At present, though, the IASC does embrace the idea of using the asset/liability framework, as it is consistent with the framework definitions they've established for assets and liabilities.

The FASB, for its part, noted that the accounting principles are consistently crafted in accordance with the framework, and they might offer the possibility of a more understandable and transparent financial reporting. However, the FASB also suggested that the next document should discuss, in greater detail, how insurance accounting based on the framework is expected to result in superior reporting. In describing U.S. GAAP, the FASB's comments were that, like

most existing systems in other countries, U.S. GAAP is, in fact, a collection of conventions. Some are consistent with the asset/liability model while others are consistent with the deferral and matching view.

Issue Two. Once we settle on an asset/liability view, how should assets and liabilities be measured? I indicated, the insurance project is taking its lead from the financial instruments project. The working assumption is that fair values will be required. What is a fair value? From the point of view of the IASC, a deep, liquid market is available on the asset side of the balance sheet, and that allows you, in those instances, to use the market value as a fair value of the asset. By analogy, we have the current definition of a fair value of the liability being the amount required to settle the liability between two knowledgeable and willing parties in an arm's-length transaction. In other words, it's the amount that you need to pay to another party for them to take over your liability. As FASB notes, although the details aren't spelled out, the IASC definition of fair value is generally consistent with the U.S. GAAP preliminary views on reporting financial instruments and certain related assets and liabilities at fair value.

Assuming that fair values do prevail, the next issue is, how should they be determined? Many of the issues relate to this question. Issue Three. How should the asset/liability interaction be allowed for? The IASC identified two principles for this interaction. The first is that assets and liabilities should be measured using consistent principles, so both sides would be on a fair-value basis. I'd venture to say that most of us in the room would agree that financials will be more meaningful when assets and liabilities can be measured consistently.

The second issue that they identified, the measurement of liabilities, should not be affected by the types of assets held or the return on their assets. What they're getting at is that the discount rate used to determine liabilities should not be affected by the assets actually held unless the policy benefits are a function of the return on specified assets. Again, this seems like a sensible approach. For example, the value you place on a fixed liability should be independent of how you choose to invest the assets supporting the liability.

In respect of this, the FASB's comments are generally supportive of the notion of market-based assumptions and those assumptions should be used for all measurements. However, in FASB's

view, market-based assumptions are not a necessary element of the asset/liability measurement approach, and the FASB recommended that the Steering Committee discuss the basis for their conclusion more fully in the next document.

Issue Four. In breaking down the fair-value liability, the IASC identified two components, the first is the best-estimate liability, and the second is an allowance for uncertainty. The best-estimate liability is simply the sum of money needed based on best-estimate assumptions that will enable you to exactly meet your future obligations when they fall due. The IASC then reflects the reality that if you are paying someone else to take over your liabilities, you'll need to pay them more than the best-estimate amount. This additional amount is a reward for risk or a profit margin required to compensate a third party for taking over the liability. For those of you familiar with the Australian margin on services, you'll recognize the idea behind these two pieces where the fair-value liability actually corresponds to what the Aussies would call their policy liability.

Breaking it down further, the best-estimate liability includes an explicit approach to assumptions that the IASC favors. The assumption should reflect all future events that will affect the amount and timing of cash flows. Finally, the measurement should reflect market expectations. In that last point, there are some ambiguities. For example, should you ignore the company's expectations? How should you address market expectations of the company's future experience? In the case of the margin for uncertainty, it should ideally be based on the margin that would be observed in an actual, ongoing transaction. But, as we know, the exchange of these types of liabilities occurs infrequently, and so it's acknowledged that the margin will need to be estimated and it is a subjective assessment. It is most likely that the IASC will call for the risk margin to be disclosed. The FASB did not comment directly on this approach in its April memo to the IASC.

Issue Five is, if you use best-estimate assumptions, your view on assumptions could change at each valuation date. Hence, you need to know how to account for the change in assumptions. Three main alternatives were considered. The prospective approach, spreading the effect over the future period, is similar to the Australian margin on services. The second alternative was a lock-in approach like U.S. GAAP *FAS 60*. Finally, there is a fresh-start approach where we fully

reflect the effect of the change in the current period. This approach gets its name from the South African fresh-start valuation approach.

The current IASC position does favor the fresh-start approach, and this view is consistent with the asset/liability framework, but is likely to lead to some volatility in profits. Those who favor this approach to assumption setting point out that users of financial statements, that are put together on this basis, can evaluate several years of data when they see that the results are based on current information and assumptions.

The FASB observed that some U.S. accounting models prohibit the use of current estimates in periods after issue while other accounting models call for current recognition via the fresh-start or catch-up approach. They didn't really state a position on this particular issue.

Issue Six is, should gains or losses be recognized at the sale of an insurance contract? The IASC does favor an approach that will end up giving rise to gains and losses at issue. The goal is to avoid prejudging how profits should emerge; rather, let's focus on the balance sheet. The Steering Committee does recognize that this approach causes concern for some parties, and some accountants are unhappy with it because it could lead to premature recognition of profits and a need to reverse the gains later. However, it considers that it's inappropriate to use artificial or conservative assumptions to eliminate gain as this would be contrary to the asset/liability framework. In the end, this could be an area where compromise will be needed.

The FASB recognizes that this approach is consistent with the fair-value concept. However, they did warn that those who will be reviewing and commenting on the proposed standards in the future might not fully appreciate the impact of this position. The FASB suggested that the discussion of the impact of this decision on the pattern of reported income receive special attention in the next document.

The deferral and matching accounting framework calls for the explicit deferral and amortization of acquisition costs. Under a fair-value framework using projection techniques and best-estimate liabilities, the deferral and amortization actually occurs implicitly within the liability calculation. You wouldn't need to explicitly defer acquisition expenses. Rather, you can deduct them from

the policy liability through the margin in the premium, which is available to recover acquisition costs. This results in what is effectively a deferral of expenses. It's just not recognized as an asset.

The FASB did not take a position directly on this issue but did point out, as we'll see in Issue Nine, that because of the use of an account value as the floor for an insurance liability, this might lead to the need to reconsider this conclusion on the capitalization and amortization of acquisition costs.

Issue Eight. Should a closed-book or an open-book approach be adopted? This issue is related to the measurement of insurance liabilities arising from the current contract. Of the two approaches considered, the IASC does favor a closed-book approach. Closed-book would mean that we're going to value the existing contracts where an obligation has been established, and renewals are included, only to the extent that the insurer is committed to a specified pricing structure. However, the phrase, "committed to a specified pricing structure," could be problematic and lead to inconsistent reporting. For example, how will liabilities be set for nonguaranteed premium rate contracts? This tentative conclusion has also generated vigorous debate among property and casualty insurers, and the debate questions whether renewals should be included in the closed-book approach, presumably by using an assumed closing ratio. There's no direct reference by the FASB to this conclusion in their document in April.

Issue Nine. What accounting model should be used for life insurance? Both a prospective policyholder benefit model and a retrospective policyholder deposit model were considered. The IASC's tentative view is that the policyholder benefit model should be favored; however, the fact that the liability should have a minimum of the policy deposit amount or account value is controversial. It actually appears as though they split the difference between the two methods. Background on this seems to be that banks were resisting the application of fair value, and one way to get around this was to establish a minimum liability at the account balance. The FASB noted that this approach is not fully consistent with fair-value reporting, and it suggests that the rationale for this position be discussed more fully in the next document.

Issue Ten is whether catastrophe and equalization provisions should be required. The IASC has taken the position that catastrophe and equalization reserves should not be held. It is a controversial position, and the IASC will be considering the need to create a separate component of surplus for specific disclosures about low frequency/high severity events. For the time being, disallowing any type of catastrophe or equalization provision will lead to volatile profits.

Another issue and concern in some countries is for the tax implications of disallowing those kinds of provisions. The FASB does support the current position; however, it notes that it's consistent with the framework definition for assets and liabilities.

I'd like to address the actuarial debate on fair values. What was considered by the IASC? There are two models being considered for the measurement of the fair value of liabilities. One is the direct value of the risk method, and the other is the embedded value method. The key difference between them is how to allow for uncertainty or risk in measuring the fair value of liabilities. Under the direct value of risk method, risk margins are allowed for explicitly in the cash flows. We'll need to use complex statistical processes to assess the risk margins. Cash flows, including the margins, will be discounted using a return based on a replicating portfolio of risk-free assets with the same cash flows as the liability. The difficulty will be in calibrating the margins as they won't be observable. Furthermore, market values aren't determined in this way. It's not going to be possible for us to fall back on market practice. A risk-free discount rate might be too conservative. For example, it might give the wrong answer for corporate debt.

The final point is also very interesting because some observers have said that allowing for one's own credit risk is the craziest idea ever floated. Others, particularly financial economists, feel that it must be allowed for, and the FASB supports the notion on the grounds that the credit standing would be considered in a fair value measure of liabilities or a transaction between two, knowledgeable parties. The FASB sees no persuasive argument to suggest that a conclusion reached for other liabilities should not extend to insurance. At the moment, *IAS 39* includes a credit standing. FASB is calling for coordination with the Joint Working Group on this point.

As for the embedded value model, we're going to use best-estimate assumptions with no margins in the cash flows and allow for the cost of holding a risk-based capital adequacy reserve and not

a regulatory reserve. We will be discounting distributable profits using a risk discount rate that reflects the risks in the cash flows. Getting the embedded value right isn't necessarily straightforward. There's a number of decisions, and many of them are subjective. You could make the argument that it's really an indirect method of valuing liabilities. Why not use the direct method?

Where could the actuarial debate from the IASC perspective end up? Provided the two methods are applied correctly and consistently, they should produce similar results. There is a furious debate going on. People are getting quite emotional over their favorite method. One possibility is to give actuaries sufficient training and background to allow them to make decisions framed within the IASC standards and principles that guide without giving too much explicit guidance. It could also leave the detailed methodology up to the individual companies.

If you'd like to stay abreast of developments in international accounting, you can find all the latest information on the insurance project and everything else the IASC is working on at www.iasc.org.uk. In preparing this presentation, I must acknowledge the contributions of Clive Aaron, a colleague of mine in the Tillinghast office in Melbourne, Australia.

MR. JOHN W. MORRIS: It's a pleasure to be here. My topic is AICPA update. I plan to discuss recent life insurance issues that the AICPA is working on.

I have four items that I'm prepared to talk about. The first is to talk about the task force that the AICPA has assembled working on nontraditional, long duration insurance contracts. Second, there's a task force on DAC for internal replacements. The third is a task force that the AICPA has with regard to demutualization accounting. The fourth topic I want to mention is the audit and accounting guide for life and health insurance entities. This has now been completed and is available for sale. I guess it's a little bit different than being held to maturity, which is what everyone thought it was going to be, (for example, it took so long to go from draft to final).

Most of these task forces are still works in progress. I don't think it pays to get into the minute details, but I do think it's important to discuss the concepts that they are discussing and what some of their ultimate conclusions might be.

There's no importance in the order of the topics I want to talk about. The Nontraditional, Long Duration Contracts Task Force is, of course, dealing with nontraditional, long duration contracts. The task force is working on a draft Statement of Position (SOP). The last newsletter said it is targeted for the end of 2000, but my understanding is that some of the members think it may slip into early 2001. Given that an SOP exposure draft would go through a 60-day exposure period, there might be a final draft in 2001, which means that, at best, you'll have guidance for the financial statements in the year 2002. If the exposure period presents some complicated issue that takes the task force longer, it could be delayed, but I don't anticipate that any effective guidance would take place before 2002 financial statements.

One topic being studied by this task force is unclear, undefined, multiple account value products. I'm mainly talking about market-value adjusted deferred annuities where there's a market-value adjustment on the surrender value. There are other types, but that's sort of the one that seems to come up in the examples more often.

The task force, as far as I know, is still undecided about how to handle this issue. They're talking about possibly using the higher of book value or the market-adjusted value with some probability of withdrawal included. Another possibility is using the highest amount that a policyholder could actually get in cash at any point in time, adjusted for surrender charges or for other related benefits. My understanding is that the task force is still discussing this.

The next issue involves variable annuities and the minimum guaranteed death benefit. I think I found, in practice, that every client of mine is doing it differently. They are either holding nothing in addition to the account value or holding statutory reserves as their GAAP reserve, and anywhere in between.

The work that the task force has done on this is to define a calculation, which determines whether the minimum guaranteed death benefit is significant or not. By doing the calculation and looking at the present value of the minimum guaranteed death benefit (MGDB) using a range of projections and not just a best-estimate and by looking at it versus the present value of amounts to be assessed against policyholders, would give you an idea of whether this benefit is significant. If it is significant, the product would be treated as a universal-life-type contract

under *FAS 97*. As such, you would set up a liability for the minimum guaranteed death benefit similar to the way you would set up a liability for unearned revenue liability. It would also be eligible for the premium deficiency calculation. If it turns out that the minimum guaranteed death benefit is not significant, then this is an investment-type contract, and your only benefit reserve is the account value.

Bonus interest is something that I keep getting questions about from a number of people. From my understanding, there's a diverse practice in the industry as to whether that's something that should be capitalized and amortized or not. My understanding is the task force has concluded that benefits to policyholders should not be considered deferrable acquisition cost, and these should be expensed as incurred. If you have persistency bonuses, you need to accrue for them during the period over which they apply. If you have a persistency bonus, in Year 10, you need to start setting up a liability that'll accrue for that over a ten-year period.

The last item that I wanted to talk about pertaining to this task force is the separate account issues. As you know, separate account assets are reported on one line in the GAAP statement, and separate account liabilities are on another line. With the products getting more complicated, it's unclear whether a contract is truly a separate account contract or not. The task force has currently developed four criteria that need to be satisfied in order to get separate account treatment. Those criteria are that (1) assets need to legally reside in a separate account; (2) the separate account assets must be insulated in the case of bankruptcy proceedings; (3) the policyholder must direct the allocation of the assets; and, (4) all the investment performance, less fees that are normally charged, must be passed onto the policyholder. If those criteria are met, then separate account treatment, which is that one-line presentation, would continue; otherwise you would report these as if they were general account assets and follow the normal accounting procedures that are in *FAS 60*, and, presumably, *FAS 115* classification would also apply.

A secondary issue with regard to this is that seed money in separate accounts does not get separate account treatment. It would get the general account treatment for assets. It should also be noted here that this task force is doing additional work directly with the FASB on *FAS 133* issues, but this is not part of AICPA work and not part of an AICPA SOP.

The next task force is the one that I represent for the Academy of Actuaries. It is—the DAC on Internal Replacements. Because the AICPA has been very busy with the audit guide, with the demutualization SOP, and with the amount of work that the Non-Traditional Task Force is doing, we're really just getting started. We've had a couple of introductory meetings to talk about concepts. There's not much to present here, other than to go over a few of the topics. I think this will be an important issue over the next 12 months, and we are hoping to develop a draft SOP on this at some point in 2001. As you may know, there was a discussion paper released in June of 1999. The AICPA got 11 comment letters. Some indicated that there was diverse practice with their company or their clients, and there's actually one comment letter that said that no guidance would be needed because that would only interfere with what they really wanted to do.

As I said, we're just getting started. With the SOP for demutualization and the audit guide completed, we should be moving further ahead. Let me just say a couple of things. There is currently limited guidance on internal replacements. In *FAS 97,* there was some language pertaining to a traditional life product being replaced by a universal life product. If that happened, you could not carry forward your DAC; you'd need to write it off. Practice Bulletin 8 basically says that this is limited guidance and should not be considered to be applied to all internal replacements. It didn't really tell you what guidance should be applied to all internal replacements. That's why this task force has been convened.

The discussion paper offered three views. View A was that *FAS 97* guidance should apply to all internal replacements; in other words, there could be no carrying forward of DAC under any circumstances. View B was that internal replacements are a continuation of the contractual relationship and the original DAC should go to the new contract. View C was the original DAC for internal replacements that substantially similar contracts should go with a new contract. View C got the most votes in the comment letters. View B got the second most votes, and View A got the third most votes. There were 11 comment letters. Don't read too much into that.

The task force has started thinking conceptually about what guidance is out there besides the *FAS 97* and Practice Bulletin 8? There's an Emerging Issues Task Force (EITF) 96-19 that talks about restructuring debt and what you do as far as acquisition costs related to that. They sort of define a quantitative measure that says if the present value of the new cash flows are within 10%

of the old cash flows, then it's substantially similar. If it's 10.1% or higher, it's not. That might end up having some bearing on the task force's conclusions.

We've talked about what would constitute being substantially similar in insurance contracts. We have not come to any conclusions or even decided that that's the view that we like. We were wondering if it has to be same line of business? If you go from a traditional life to an annuity, is that substantially dissimilar? I'm guessing it is. Is the replacement the same GAAP model? If you're going from a *FAS 60* to *FAS 97*, are there any situations where you would view that as substantially similar?

The third one is the one that I think is going to end up with the most discussion, and that's do the contracts present the same risks? You now see a lot of fixed deferred annuity contracts being replaced with variable annuity contracts. It would be hard to argue that substantially similar contracts exist when the investment risk has gone from the insurance company to the policyholder. Again, we haven't reached any conclusions. Finally, what are the quantitative measures? As actuaries, we would love to do some quantitative measurements.

The last task force I wanted to talk about is demutualization accounting. I don't want to go into this in a lot of detail because it is of limited appeal to companies that have demutualized. There was an exposure draft earlier this year. Comments were due in June. We expect the final SOP any day now. The AICPA and the Executive Committee have finalized their work. It's now waiting for the FASB to approve it. My understanding is that there's very little change from the exposure draft. The demutualization accounting called for combined financial presentation. A lot of the companies that have closed blocks treat closed blocks similar to the way we treat separate accounts, meaning there's a one-line asset and one-line liability entry on the financial statement. The SOP would require you report all assets together. The SOP also suggests that SOP 95-1 or *FAS 120* should apply to contracts issued after demutualization that are participating. In addition, demutualization expenses are to be treated as ordinary expenses. This is more of an accounting issue but clearly a change in what some companies have been doing.

Transition rules were rather tough in the original exposure draft. It said that companies need to go back to the date they formed their closed block and restate their GAAP statements. My

understanding is that the revised SOP will give you a little bit of leeway, particularly for companies that demutualized a long time ago. You don't necessarily have to do that if it's overly expensive or hard to do.

The item I saved for last is the actuarial calculation and policyholder dividend obligation because that's sort of the crux of what the actuaries are interested in. The actuarial calculation is what we refer to as a GAAP glide path. It's a projection on a GAAP basis of all the assets and liabilities in the closed block, and the SOP essentially locks that into place. For the duration of the closed-block projection period, your GAAP profits are pretty much set in stone. If experience is more favorable, then you would set up a policyholder dividend obligation (PDO) to account for that, assuming that what you're going to have to do is increase dividends later anyway. Any favorable experience would get absorbed in that liability and not get passed on to your GAAP income. There is a requirement that the PDO must be nonnegative, which means that if, in the early years, your experience is less favorable, then your GAAP profits would be lower. You would recoup that later when you actually reduce dividends to account for that less favorable experience.

There are a couple of calculation issues that I don't think were clear in the first SOP. I'm not sure whether they'll be addressed in the revision. One is a change in the PDO that needs to go into your expected gross profits (EGP) calculation in deferring DAC under SOP 95-1. Not all the PDO are contained in your EGP. For example, taxes are in the PDO but are not part of the EGP calculation. I don't know if further guidance will be available on that or not. If you're locking into this GAAP glide path, and your closed-block terminates early, I didn't see any provision that would allow you to terminate your PDO early.

Finally, there is now a new audit and accounting guide for life and health insurance entities. It discusses GAAP accounting and audit items that are unique to life and health insurance companies. It is not a complete audit manual. Things that are common to all industries are not in it. There is statutory discussion in there, but it does not include codification. Remember, the initial draft came out in 1998. There's no new accounting standards and no new interpretation of existing accounting standards. It's basically just reference material that will direct you to where the accounting literature is.

How can you get a copy of this guide? Without sounding like an infomercial, you can go to the AICPA's Website, www.aicpa.org/store/product/012500.htm. Have your credit cards ready.

MR. MICHAEL L. EMERSON: My question is for Alastair. It relates to your choice of the 15th to 30th percentile corridor. One of your slides indicated you were influenced by your ability to choose between two equally likely scenarios—one above the mean and one below the mean. I think that same slide indicated that your choice of the corridor below the mean provided some margin and some consistency with fair-value reporting. My question is, how does that relate to *FAS 97's* language regarding best estimates? Why did you choose a corridor that did not include the mean?

MR. LONGLEY-COOK: I think these are really different issues. One has to look at *FAS 97* on its own and fair-value accounting if and when it comes along on its own. I don't want to muddy the two.

If you think about what a fair value would be for any asset, for instance, or any liability that has uncertain cash flows, the fair value of that is generally not the expected value or the mean. There is a market value margin or a risk premium that is usually charged so that any risk averse entity would not pay the expected value. That is not part of current accounting, but it is a theoretical justification of why you don't choose the mean.

The reason for choosing a corridor left of the mean within the context of *FAS 97* is based on the concept of conservatism that *FAS 97* doesn't rule out. All it says is that you shouldn't have an explicit provision for adverse deviation. If you're faced with two equally likely choices, you'd choose the more conservative one. Here we have a *continuum* of different possibilities. You could run these scenarios day and night and come up with hundreds of thousands of different possibilities. You don't have only two to choose from. One way to look at that would be to say that choices that end up one standard deviation below the mean are equally likely as ones that are standard deviations above the mean (if it's a symmetric distribution, of course). I think that could be a justification.

What a lot of companies are doing now might be harder to justify if pressured on whether or not they're making provisions for adverse deviation by assuming there's going to be a correction or by assuming equities are only going to grow by 4% for instance.

FAS 97 was written without this issue in mind, but I believe that our approach would both conform with that language but also be consistent with what a financial economist would think would be a reasonable value for something with that much variability in the results.

MR. IKWAN OH: I'd like to offer some comments on the stochastic DAC projections. First, I want to thank Aetna for coming up with this very creative approach to solving this DAC volatility problem. We at Prudential Annuities have similar issues. I recently talked extensively to Dick and Jay at Aetna about this approach. We are in the process of implementing the same approach at Prudential, but we have some comments about some of this history. There's another approach dealing with the DAC volatility, and you assume different kinds of future returns to average out from the history to the future to some long-term expected return. That approach actually is the one that we are using right now. We are thinking about replacing that by this stochastic approach, because we did some simulation projections over many years and found out that that first approach only gives you 30% or 40% on the average long-term reduction in the DAC volatility.

I think we agree with Aetna's philosophy that DAC is not a single number, especially when we talk about the separate account. There's no single number to talk about. There's a range of returns, and any one of those could represent a DAC number. We are not changing the *FAS 97* interpretation. We're just changing our assumptions, and we have a range of assumptions that happen to be scenarios. We run the DAC, and all of those could be a possible DAC number.

The question is, from where do you get the proper DAC number? In terms of the corridor, we found that we have a trade-off between the desire to reduce the DAC volatility, and having a wider corridor where you tend to fall in that corridor most of the time.

When we do these stochastic projections, there's a potential way to solve the problem in terms of where you put your corridor. I think it potentially depends on where you start your current DAC

and what assumptions you use when you do the stochastic projections. I think one good thing about the stochastic projection is this corridor should reflect the trend of your business. If you have consistent bad persistency in terms of lapse, you should come down further because eventually you're starting from lower income in-force business and projecting it forward. Suppose you have a consistent bad market for four or five years and your corridor also comes down. The corridor will smooth out short-term volatility. That's the good thing about a corridor.

MR. LONGLEY-COOK: Thank you very much for those comments. There's definitely a dynamic that exists among what the actuaries are trying to do, what the accountants are trying to do, and what management would like to see. It all needs to be balanced. We did a fair number of sensitivity tests to make sure that this corridor was dampening out the short-term fluctuations without being so broad that it wasn't taking into account more long-term changes in assumptions; it is therefore bringing DAC into line with that. Management, on the other hand, has been coming out of a period where there was a lot of freedom around what assumptions could be made and, what earning targets you could hit. I don't think that's the world we're in anymore. If you are in that world, then you're exposed to criticism from the SEC. There is a balance, and the corridor should reflect both the volatility of the actual equity funds that those investments are in and the way you've set up your business and how big it is versus the rest of it so that you have a manageable balance between those different goals. Over time, I think you end up with a guideline or a set-up that still holds together. We just implemented it, but the tests indicate that it is pretty robust.

FROM THE FLOOR: I have a few questions. One has to do with dealing with this corridor. If I understand what both of them were saying, it seems like the use of the corridor is kind of induced by management's perception that we want to stabilize earnings or stabilize the change or not have a change (if it's not too big), rather than reflecting the full change. What hits the income statement is your unlocking effect? What doesn't hit the income statement, but rather hits your comprehensive income, is the difference between your mean or expected value and whatever your corridor is. It's always hitting your balance sheet. What hits your income statement between your GAAP income and your comprehensive income is a balance between this corridor approach and your comprehensive income approach.

MR. LONGLEY-COOK: Right. I agree.

MR. WHITE: We had had a general question submitted at the beginning of the session that I'll read and throw open for discussion. For insurance plans that normally fall under *FAS 60*, but that have increasing premium, what are some solutions to obtaining profits as a percentage of in-force business instead of as a percentage of premium? Is the limited payment feature that's commonly used with *FAS 97* and the unreleased profit reserve appropriate for this use? Do you want to start with that, John?

MR. MORRIS: I'm not 100% clear on it. If it's clearly a *FAS 60* product, I don't think you have an option of amortizing DAC over anything other than premium. If the increasing premium is nonguaranteed, then I think that would fall under a *FAS 97* concept. Or, if the premium is a limited-pay premium, then you would generally calculate benefits reserves and things like that according to premium, but your DAC amortization would be based on in-force business. You'll never get profits that are a level percentage of in-force business, but it'll be a combination of certain items that are a percentage of premium and others that are a percentage of in-force business.

MR. SMITH: I would agree.

MR. ROBERT J. LOMBARDI: One last question for Alastair with the dynamic method. If a company had a variable universal life (VUL) product, that seemed to have volatility because the asset-based profits are different than the mortality profits, might that technique be adaptable to the UL?

MR. LONGLEY-COOK: Aetna doesn't have UL anymore. We didn't give a lot of thought to that, but I think it's applicable. Maybe there's not as much need because that source of profit might not be as overwhelming as it is with the variable annuity because you have other sources of profit. Maybe there's a little less volatility in that product, but if you're doing it for variable annuities, you might want to look at it for VUL as well.

FROM THE FLOOR: I have a mechanical question for Alastair. What rate are you using for the discount rate? Are you using a risk-free type discount rate or are you using the stochastic generated interest rates?

MR. LONGLEY-COOK: We're using the average credited rate in the year of issue for each cohort as in a standard deterministic calculation. The average rate is a weighted average of the fixed and variable credited rate. We generally use a long-term variable credited rate for each issue year using the actual variable return.

FROM THE FLOOR: Regarding the DAC income impact, I think if you don't have to unlock, then you certainly won't have income hit. If you do have to unlock, for example, to the boundary of your corridor, that will hit your income. On DAC, it is just a reservoir of your expense. It has to be released some day.

FROM THE FLOOR: Maybe it's time for a workshop on the corridor rule. Have your auditors accepted the concept of a range for DAC?

MR. LONGLEY-COOK: Yes.

CHART 1
DAC in Corridor—No Catch-up

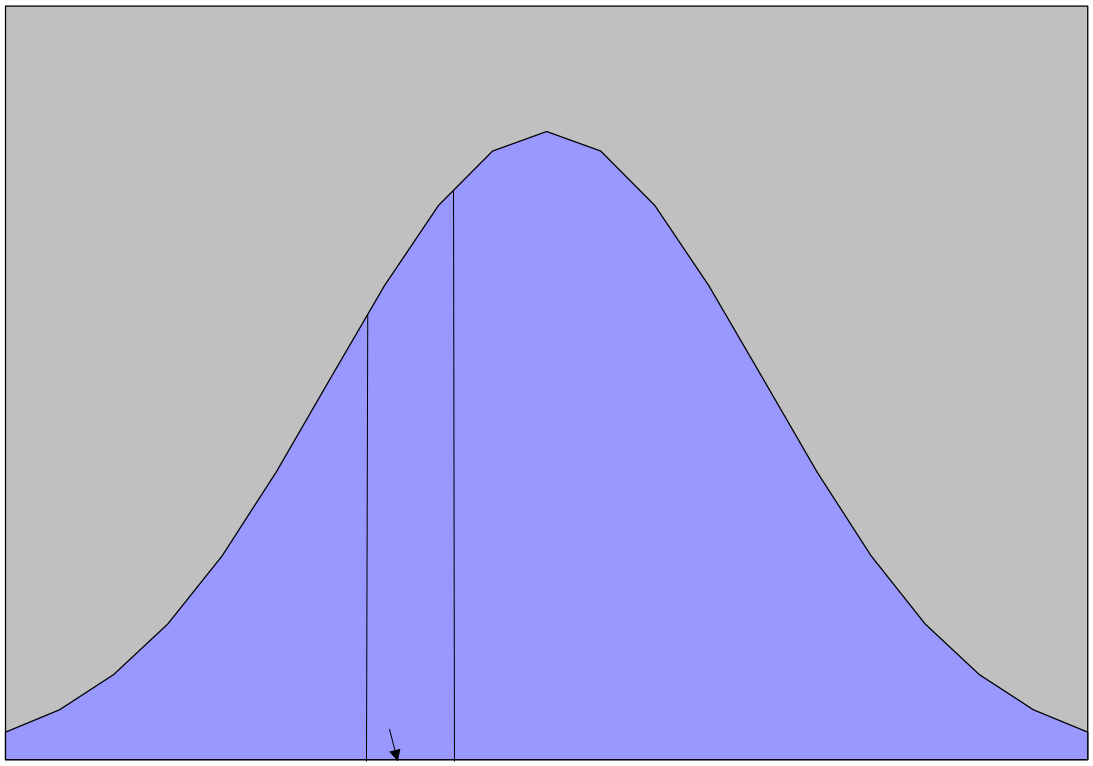

CHART 2
DAC Below Coordinator—Positive Catch-up