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Session 44OF
Ask the Experts

Moderator: Daniel J. McCarthy
Panelists: Mark Davis
David N. Becker

Summary: This open forum is designed to address issues not fully discussed or addressed in other sessions.

During this session, you hear opinions of experts with varying backgrounds on questions dealing with a variety of subjects. Time is spent both on questions submitted in advance and from the floor.

MR. DANIEL J. MCCARTHY: I'm a consulting actuary with Milliman and Robertson in New York. Mark Davis is a consulting actuary with Tillinghast in Chicago and manages that office's financial services practice. Dave Becker used to be the chief actuarial officer of the Lincoln until quite recently. We are going to talk through some questions that have been submitted in advance. We'll take questions later. My experience from these panels, is that the advance questions are usually useful in getting us off to a start, but they are often not, by any means, the only questions people want to talk about.

We will, to a certain extent, take them in the order they were submitted. The first one that was submitted was a question about codification of statutory accounting. This one was diligently sent to me in advance by e-mail. The question said, "Under the new codification of statutory accounting rules, the language suggests that the presence of any mortality and morbidity risk would seem to cause a contract to be classified as a life contract, rather than a deposit-type contract." It goes on to say, "Is the official prevailing interpretation going to be that the presence of any mortality or morbidity risk will cause a contract to be classified as a life contract?" I'll start the discussion on this one.

First, the answer given at the codification teaching session, was basically, yes. The codification documents, particularly accounting pronouncement #50 and the issues paper behind it, say, "a deposit-type contract is one that does not have any mortality or morbidity risk." Now it would have been nice if they had gone on to discuss a little further, the question of a contract, which does not have that risk today. It's not in the money. You might have it at a future time. An example given in the question is that of a deferred annuity?

I would say it is clear in the codification document that a deferred annuity, which has annuitization rates guaranteed in it, is a life contract. The question brings out the fact that this is not the same as the GAAP interpretation. The issues paper specifically says that, for statutory purposes, the GAAP interpretation is rejected.

The questioner goes on to point out two potential implications of this. One has to do with premium taxes. Assume for the moment that you're in a state that has a premium tax for annuities. There aren't too many, but there are still a few. Does that mean that you must now pay premium tax at the point the money comes in the door, as opposed to treating it as consideration or something else and then only paying premium tax at the time of annuitization?

The codification documents are silent on this. They do not speak specifically to premium tax interpretations. I frankly don't think it was intended that this changed the rules for premium taxes, but if you look at the documents, you see that it literally uses the word premium. That's an issue that might still be subject to clarification. By the way, I do not know what the blank is going to look like. I'm told that the new blank is out now. I do not know if the old line 1A consideration type thing is still in the new blank or not. That makes it worse. If it's gone, then you have one place to put that number. I don't know if that was intended, but that seems to be a result.

The second part of the question points out that that would make it a premium for C-4 purposes. It was pointed out in the codification teaching session that there is currently work underway to reanalyze the RBC formula in light of the codification changes. I don't know whether that will be picked up in C-4, or whether the factor will change. That issue was identified as one of a host of issues that affects the RBC formulas under codification.

MR. WAYNE E. STUENKEL: We've come to the same answers that you have about the single premium deferred annuity (SPDA) but an even more ridiculous example is a guaranteed investment contract. Most of the GICs that we sell in our company have annuity benefits that are guaranteed in the contract. We've never expected anyone to take an annuity from Protective Life, but the fact is that there is guaranteed purpose rates in the contract. We're having an internal discussion as to whether or not that's a deposit or a life contract.

MR. MCCARTHY: The issues papers give examples of some of the kinds of things that will usually be deposit-type contracts, and GICs are listed as one of them. It says, "... if there is no mortality risk." It's very clear. It uses the phrase survivorship or death in the contract. Many companies either issue those in the form of funding agreements, if they can do that in the state in which they're issuing it, or they simply leave out annuity purchase guarantees. You can find older contracts with those in them. There was some old federal income tax implications that aren't around anymore. Most of the GICs that I've seen issued today do not have purchase rate guarantees. I don't know if anybody else has any thoughts on that.

The next question pertains to accidental death and dismemberment (AD&D) contracts, filed on a group basis, in a group trust, marketed directly to individuals, with a level premium structure. Are contracts, or what we would call active life reserves, required? The questioner went on to observe, that the 5980B table would seem to be excessive for that purpose. He also believes many companies are simply holding on to their premium reserve and questions whether that's appropriate. Do either of you want to start?

MR. DAVID N. BECKER: At Lincoln, we had a block of accidental and dismemberment business (AD&D) that has now largely expired. Although it was issued under a group master contract to a group trust, it was effectively individual contracts. Many of these products had a return of premium feature if the contract did not result in a claim during the coverage period. The coverage periods ranged from ten to fourteen years. We did not avail ourselves of any of the leeway under the valuation laws with regard to group contracts. We valued it as individual contracts following statutory reserving principles.

MR. MCCARTHY: It might have something to do with whether the rates are guaranteed or whether the contract is cancellable.

MR. MARK DAVIS: It probably boils down to whether you are going to be aggressive or safe, and if you're going to be aggressive, you can hide behind the group nature of the contract and perhaps do what you would like. If you're going to follow a more principled approach, like actuarial principles with level contract increasing costs, you're probably going to compute the active life reserves.

MR. MCCARTHY: Depending on the age it cuts off, they might or might not be significant. If you look at the rates in these contracts, they're kind of low. They don't leave a lot of room for much of a reserve. The second question is one that I will note. I'm not sure we're going to discuss it much. The question was, how should separate account reserves be handled for tax purposes? There's a provision in the tax code, in Section 817, that tells you how to go through all that, and how to take the increase and reserve out. The question is phrased very generally. I don't think we are proposing to have a complete discussion about Section 817 and the way it works. If there is anything specific that anybody would like to propose, we can perhaps take it up.

MR. CHARLES D. FRIEDSTAT: We talked about that in my tax session.

MR. MCCARTHY: It takes at least 15 minutes to have a substantive discussion on this. The next question is related to variable annuities, but it is not a reserving problem. The problem is, how do you deal with management? I think the question is asked by a company that might be fairly new to issuing a sizable amount of variable annuities, because the question noted that the reserve that you would be holding would be quite volatile, depending on the asset performance. The person is wondering how you would explain the volatility of the reserve increase from month to month or quarter to quarter to your management? My own answer to that is, “The assets are moving in the same way. What’s your problem?” Sometimes you can’t say, “What’s your problem?,” to a company president.

A different question, having to do with simply doing an internal financial projection, is how are companies projecting that volatility? I would suspect that if a company is projecting its year-end position, it’s probably using some assumed rate of growth, and not typically bothering to do some kind of stochastic projecting for something that really wouldn’t have much of an effect on your bottom line in any event.

The next question puzzled us a little bit. How are companies calculating the fair value of policy loans for GAAP? You don’t have to calculate the fair value policy loans for GAAP. By the way, if you were doing total fair-value accounting, which isn’t GAAP, you’d have a different question. I believe, you’d be linking up that policy loan asset with the appropriate liability and doing netting or something like that. That’s not the way the question was asked.

The next question pertains to financial reporting. It basically has to do with your closing cycle at the end of a month, quarter, year, or whatever. The person wanted to know if companies are getting their GAAP and statutory closed at the same time, or if companies are still, as was done by many companies years ago, closing their statutory first and then doing GAAP adjustments. I’m going to take a show of hands on this later. Think about practices you are familiar with. Does anyone want to offer any thoughts?

MR. BECKER: Historically, we had determined statutory liabilities before GAAP liabilities. We typically made statutory-to-GAAP adjustments. In more recent years, we moved to determining statutory and GAAP valuation amounts in parallel where possible. At the time I retired, the GAAP balance sheet and income statement was complete prior to the statutory balance sheet and income statement.

MR. MCCARTHY: I'm going to ask for a show of hands. Think about your employer if you work for a company or a company with whom you're familiar if you're in a consulting or other capacity. Is the process for financial reporting still fundamentally a process of doing statutory financials first and then doing GAAP adjustments or do you do GAAP directly? The choices are: (a) do statutory with GAAP and then make GAAP adjustments, or (b) do GAAP directly. How many for (a)? How many for (b)? It's about 50/50. I think the majority do GAAP directly. At least I would observe that companies that used to do a stat with GAAP adjustments now would be operating in separate but parallel processes. You see that more and more.

The next question dealt with supplementary contracts. Is it appropriate to use the annuity valuation rate for all supplementary contracts. Assume that they are payouts with life contingencies without regard to where the money came from; in other words, give no regard to whether it's a maturity of a deferred annuity, a death benefit under which they've opted for a supplementary contract or something else. I think we all concluded the answer to that is yes. We didn't know of any other practice, other than to ask what kind of a thing is this? I'm aware that some companies have had discussions and have said, "It's appropriate to use the annuity valuation rate. On the other hand, it isn't brand new money. There have been arguments about whether we should use some kind of a lag rate? I believe most people would use the rate as though the money came in today, and would, in any event, use the annuity rate.

The next question is about guaranteed benefits separate accounts. The question is, what liability do you hold and where do you hold it? This, I suspect, might depend on whether or not you are licensed in New York. If you're licensed in New York, there is a fairly specific regulation on guaranteed benefit separate accounts in which you would hold a liability in the separate account. Depending on where you stand and whether those guarantees are in the money, you also might have to hold a supplemental general account liability, which would turn up in the blue blank. The reserve liability is not necessarily just the accumulated value of the contract if the assets in the separate account are not adequately supported.

There is a new NAIC model regulation on guaranteed separate accounts that speaks to reserving. It is modeled after New York Regulation 128 and somewhat after the California Legislation Regulation that has not yet been adopted; however, I think it's pretty specific.

MR. MCCARTHY: I want to comment on the not-yet-adopted part of that, because under codification, it, in effect, will be adopted for every state that adopts codification. That's because all the models that deal with reserve liabilities are part of codification. If a state is in that position (and most states will be in that position effective January 1, 2001), this will suddenly become the guidance that it will have to follow. It is worth looking back through the models to see what is there that you've never had to deal with that you might have to deal with.

MR. BECKER: The next question pertains to mirror reserving requirements for reinsurance transactions, particularly coinsurance transactions. Is it necessary that reserves match as long as each company holds an appropriate reserve for its own share? I believe that the only jurisdiction where strict mirror reserving is required is New York. When I was at Lincoln, we filed a statutory statement in New York as Lincoln National Life Insurance Company was an authorized insurer in New York. Traditionally, it has also been Lincoln's position to follow the reserving basis of the ceding company. Currently, however, there are special situations (for example XXX), where Lincoln holds reserves per Indiana law, and these reserves might be different than the reserves computed by a ceding company subject to XXX. In this case, the ceding commission reflects our holding lower reserves. At the request of the ceding company, Lincoln will hold the higher XXX reserve with a corresponding higher reinsurance cost.

MR. MCCARTHY: We decided not to deal with the question of what ultimately happens to those reserves when you get to the second, third, fourth, or fifth reinsurer, that might be domiciled in a certain state.

MR. BEN PETERS: Say you have a quota share and you're trying to do a GAAP reserve, and a cancellable product, where the reinsurer doesn't have the authority to cancel, but the direct writer does. Could you have different reserves in that situation?

MR. BECKER: I don't know what the position would have been on that.

MR. MCCARTHY: What you're saying is that it's cancellable by the direct writer, but not unilaterally by the reinsurer. That's an interesting point that I've never heard raised before. In a sense, it is worse than mirroring. It is at least higher than mirroring, so I don't know if that's worse or not.

What is the appropriate level of aggregation at which DAC recoverability should be done? The questioner propounded as possibilities, by line of business, by company, by market, or by distribution channel? One that is missing from the list that I would have added is by GAAP reporting segments. I think if you were actually reporting at the segment level, you sure can't go higher than that for aggregation for testing. Are there any thoughts about that? Some companies go lower.

MR. DAVIS: When I see recoverability, it's usually done, not quite at the product level, but maybe at the product segment level. I don't know of any requirement that it must be done at some level. I guess the more aggressive approach is to do it at the higher level, and if you did it for four or five product segments, you're going to end up with a less-than-aggressive answer.

MR. FRIEDSTAT: This is a question that often comes up. The wording in the FASB guidelines say "line of business level." The meaning of "line of business" might mean something different to some people. We have used some of the criteria that have been used. I've seen it applied much more narrowly than what you and I would call line of business. I've seen it go down to a product level. Issues that come up include, "Is universal life a separate line of business from traditional life?" There are arguments on both sides. There's not a lot of hard guidance on it. What we would normally use as a line of business level is acceptable, but as long as you're more conservative and can go down to a narrower definition that seems to be acceptable.

MR. BECKER: On a pragmatic basis, at Lincoln, in the reinsurance division, we tend to group all individual life insurance together. Then, financial reinsurance, of course, is never supposed to have a problem. We actually did prove that there is risk transfer in financial reinsurance, much to our chagrin. It's the oops factor. There's something about high impact, low probability. The health area, including the disability income and reinsurance, was a separate line. On the direct side, disability income (DI) was treated separately from the life insurance, on a stand-alone basis. We did tend to separate life by universal life, versus traditional life. We weren't required to separate them. As Bud said, what is a line of business? We felt that the risk characteristics were sufficiently different. We also tend to follow the lines in our company. We have grouped similar products with similar risk characteristics. We have a number of different segmented investment portfolios, backing specific collections and liabilities. That's literally how we manage the business. We have always looked at loss recognition as following how we manage the business. If we had two segmented portfolios, we would not combine the two together to avoid a loss recognition problem. That is how we have done historically.

MR. JOHN DIJOSEPH: I was the one who raised the line of business issue. We have an offshore company that writes a lot of international business. The question that we asked our auditors, which they haven't yet responded to, is if you're writing the same product (for example, term life) in several different countries, do you need to consider each country separately, for recoverability, even though we manage the results of the captive as a whole?

MR. MCCARTHY: You don't use country as the differentiation for GAAP reporting segments?

MR. DIJOSEPH: No. The only audited statements are for the captive as a whole.

MR. MCCARTHY: Okay.

MR. DAVIS: I assume you're talking about audited financials.

MR. MCCARTHY: Yeah, I'm talking about GAAP segment reporting. Some companies do this, but even then, those segments are usually very broad. I've never seen them differentiate segments at levels below the distribution channel or fundamentally different kinds of business. It's not as Bud was saying, at the level of universal life versus ordinary life or something of that sort.

MR. DIJOSEPH: We do that internally for management reporting purposes. We break them out a little finer, but that's not audited. You basically track it.

MR. MCCARTHY: I think we're saying that we don't know of any requirements that go down to that level. I shuddered when I read the next question. This deals with U.S. companies with foreign branches, meaning foreign operations not in a subsidiary, but in the company itself. It is harder for a branch. I think you get a very different answer in a subsidiary. Let's treat it at a branch level first.

What is the appropriate basis for tax reserves for foreign business of a U.S. company for U.S. federal income tax purposes? Is the U.S. statutory minimum appropriate for foreign risks? Could reserve contingent statements required by the foreign jurisdiction be used? How does this differ from resident and nonresident taxpayers? This is a real issue for a number of companies who do business in certain parts of Asia. It has been necessary, from a capital point of view, for them to operate with a branch, rather than a subsidiary. The capitalization requirements were prohibitive. For mutual companies, it was and still might be impossible in Taiwan to operate through a subsidiary. So people have had to deal with this.

I know of some companies that are using the U.S. basis, but I do not know if there is any other guidance. I'm aware of companies that use the U.S. basis. If it's in a branch, and you are a U.S. company reporting, you have liabilities under U.S. reserve reporting bases. I believe that's what you use. It is a little more complicated than a subsidiary, but I believe subsidiaries are reporting under the foreign rules.

MR. FRIEDSTAT: I think you're getting into some potential areas that are very complicated, to the extent that there are Sub Part F implications. There are considerations apart from the general U.S. tax rules. Rules also differ depending upon the country. There are certain things on their investment. It's certainly beyond the scope of what we can talk about here. I'm probably not the best person to talk about it. Sub Part F has received a lot of attention in the last couple of years. There has been some legislation to clarify certain things. Companies that I've dealt with struggle with how to do this in various different countries.

MR. MCCARTHY: That's more an issue of operating through subsidiaries than it is if the business is on the books of the U.S.-domiciled company.

FROM THE FLOOR: That's where the Sub Part F issues come up. That's where most of the questions are. I think it's on the books of the U.S. company and maybe a clear request. You just apply the U.S. rules. I'm generally agreeing with your direction.

MR. DIJOSEPH: I guess I'm struggling with the thought of using a basis that is based on U.S. mortality tables, when you're talking about jurisdictions like Australia or the United Kingdom or Seoul, which is so dramatically different. If you use a U.S. basis, you could have a completely different result.

MR. DAVIS: I've got a solution for you. One of the things in the tax code talks about so-called "adjusted" as appropriate language. You can adjust the table as appropriate for certain risks, and one of the examples that was given was foreign risk. I'm pretty sure that you could easily modify the table legitimately to reflect that risk. That shouldn't be a problem.

MR. MCCARTHY: Of course, you might be arguing with the auditors forever as to what appropriate is.

MR. PHILIP J. BIELUCH: In the Taiwan business case, in order for it to be a life reserve under Section 800, it had to be under Section 7702. The first sentence of Section 7702 has the words, "something approved by a State Insurance Department." There's even a question there.

MR. MCCARTHY: I thought you were going to comment on some of the products sold in other countries. Because the customer doesn't have to worry about Section 7702, it would often comply and Taiwan is a good example of a very high-premium, high-cash-value market. Forget about whether it has been approved by a supervising authority or not; it wouldn't comply anyway.

The next question deals with the GAAP treatment of the bonus interest on a bonus annuity product. The questioner says, in effect, although he doesn't use this term, that it's sort of like an acquisition cost. Why can't you defer it the way you would defer acquisition cost? Various possibilities are laid out here. The fundamental point of it is that it's a one-time cost. Why can't you defer it and spread it as you would any other acquisition cost?

MR. DAVIS: When I was first confronted with this, I was surprised to see that the company that I was dealing with was capitalizing bonus interest and deferring it. It runs into some pretty large numbers and some pretty big impacts on earnings. The way I first thought of it was this is a benefit, and you can't defer a benefit can you? Dan brought up a good point earlier. Let's say the bonus was just 1%, and the company with the 1% bonus paid a 3% commission. Then you have another company off to the side paying no bonus but a 4% commission. You'd think that they ought to be reporting pretty close to the same basis. If you don't defer the 1% bonus, you get what seems to be an anomaly. There are arguments for both sides on this one.

MR. BECKER: We had that issue at Lincoln as we offered an annuity product with both a 4% and a 5% commission; however, the product with the 4% commission had a 1% interest rate bonus. In that case, the interest crediting rate for the first year was 1% higher than for the contract with the 5% commission. In that light, the additional 1% credited rate certainly seems similar to an acquisition cost, although it appears in the GAAP liability. When we visited with our auditors on this issue we found that there were different practices being followed in the industry for accounting for the bonus interest. Some companies capitalized the amounts, and others did not do so. Similarly, accounting firms had different positions on this issue. Another situation where this occurs on a rollover is when the new insurer credits an extra amount to the account value to reimburse the policyholder for any surrender charges occurred in rolling the policy. Others include persistency bonuses and excess interest credits on dollar-cost-averaging balances during the first year of a variable annuity deposit. These devices are term “sales inducements” by a subgroup of the AICPA. An early draft of a paper on sales inducements indicated that they would not allow the capitalization of sales inducements. There is now the possibility that these amounts may be allowed to be capitalized, but it isn’t clear if they will be allowed to be presented as deferred acquisition costs (DAC) on the balance sheet. There might be a requirement to show it as a pre-paid expense or a contra-liability.

MR. FRIEDSTAT: There was a very good session on GAAP, and the panel talked about this. I think everything that has been said is accurate. If we think back to the beginning of *FAS 97* we’d see that things have gotten a lot more liberal over the years. I think that in the early days, the only thing you can even consider for possibly deferring were those situations where you had two identical contracts. You were just giving the commission to the policyholder, and that was at least something to consider. Over the years, and in the last five years, companies are more aggressively deferring these amounts, and there is not that correlation. I think that’s what has led to this. It’s not the AICPA insurance companies committee that deals with this anymore. There are the ad hoc task forces that are dealing with the ones on sales inducements. Unlike some of the other things that they are still considering, sales inducements is something that they are not going to permit.

MR. BECKER: I’d like to show you the subtlety. Quite often, when variable annuity contracts bring in a large chunk of money, the company wants a dollar-cost average. One of the things companies have given is a teaser rate on money that goes into the fixed account. Your money is in the dollar-cost-averaging bin, and it’s moved out. You get a very attractive rate on that. We’ve had internal discussions. There are different camps inside. Some people want to capitalize it, and other people don’t.

In addition, we have had calls from securities analysts, and the nature of the calls suggest to me that securities analysts would not look favorably upon the capitalization of some of those types of items.

FROM THE FLOOR: In the situation that Dave Becker was describing, with respect to the reimbursement of the surrender charge that would be incurred on the rollover, there's sometimes an additional fee that's extracted for such contracts. In effect, in return for giving them the bonus, you're going to charge them a higher management mortality and expense (M&E) charge. What I've been thinking is that seems to constitute a loan from the insurance company to the policyholder in return for a string of payments. It would seem to be possible, although I haven't checked it out with anybody. I'd be interested in the thoughts of this group, as to whether, under that kind of construction, you could argue for putting the loan on your balance sheet as an asset. Could you charge the additional fees against it as a form of repayment? In that way, it has achieved the same objective as you would achieve by capitalizing it through your deferred acquisition cost.

MR. MCCARTHY: Using your example, where you get that benefit and then you have a higher spread, it seems that, to the extent that GAAP principles mean anything, and if you want to think about revenue/expense matching, you shouldn't have to go the tortuous route of the loan to get to the same answer.

FROM THE FLOOR: It would just be the model under which you would get to that answer. I think the accounting profession has tended to look at deferred annuity contracts as a financial instrument. It is, in effect, a loan from the policyholder to the insurance company on which the insurance company pays interest. It needs to be another loan in the other direction, and you might argue for right of offset or something like that. It would seem like you could get to the same accounting results through that sort of construction.

MR. FRIEDSTAT: It's interesting. You've been talking about this almost as if it's in an individual policy context, but I see this as being in the group pension area. It is not uncommon in situations for a group pension case to come over and say, "We'll pick up any surrender charge, and, in essence, take a charge out of the future spreads." That's why I've encountered more of this issue than on an individual basis, although maybe there is a trend. It becomes more complicated. There are other real deferred acquisition costs, yet you can look at the recovery of this cost over a different stream of years. Let's say you recovered this cost in five years and you were amortizing your deferred acquisition cost in ten. Do you have two separate streams or do you consolidate it? It gets into much more complicated issues, and I'm not sure that the sales inducement task force really looked at all these specific examples. I think that they focused a lot on the bonus interests and that was most visible and causing the most discussion. There are other situations that are a bit more complicated. In relation to David's position, there might be other arguments to, in essence, accomplish the same thing in the debt area and in one of the group pension situations. We need to get into that discussion.

MR. MCCARTHY: It's ironic that I think this is caused in part by deposit accounting and the way it works. If we were in a *FAS 97* or *FAS 120* model, I think that all would get spread. It's kind of ironic that when you step into a different construct, you don't get that anymore.

MR. FRIEDSTAT: That's part of the argument on GAAP. I'm not an expert on this, but you can get into *FAS 91* (which is more deposit accounting) and *FAS 97* for these products. You might have some arguments. It's obviously more complex than this, and there have been white papers that we've issued about this to various clients. I think you might have a different answer, or at least more arguments if you're dealing with a group area where you can use more of a deposit (*FAS 91)* format accounting. The loan concept has some merit too.

MR. MICHAEL P. SPARROW: We've had kind of a similar situation for which we have obtained a little bit of guidance. If it's structured with a vesting period, you can accomplish something like deferring where you're basically expensing that over the vesting period.

MR. MCCARTHY: If you just credit it, even though you have a surrender charge there, you don't get the same results.

FROM THE FLOOR: Right.

MR. MCCARTHY: We have worked our way through the questions submitted in advance. We have a few other observations that we've written down that we thought would be good closing reminders, but we're not necessarily in a position to close yet. We'll take questions from the floor for anybody with questions or observations on statutory issues.

MR. J. HARVEY CAMPBELL: I'd like your views on a question that we've been facing with our auditors. We're in a holding company structure and our chief underwriter happens to be in the holding company where she works for different operating companies. We want to defer (or DAC) some of her salary. Our auditors say that her salary is a management fee. It is a fee paid to a holding company that is not ever "DACable."

MR. MCCARTHY: This is a situation in which we'd say, we know what the right answer ought to be; how do we get there?

MR. BECKER: When you say underwriter, do you mean a life underwriter?

MR. CAMPBELL: Yes, she is a life underwriter. She underwrites cases, but she also sets policy for the company as a whole.

MR. BECKER: In light of what Dan said, I think we know what the right answer is. I think we know what ought to be fair anyway. Is there any way to structure her compensation in a manner that is more chargeback? That's what we would try. Get it out of the management fee realm. Remove it from the realm that caused the tainting of the object. Underwriting fees ought to be capitalizable.

MR. DAVIS: You might want to consider different auditors as well.

MR. MCCARTHY: At least that comment was not made by somebody who works for an auditing firm.

MR. DAVIS: I just said "consider."

FROM THE FLOOR: There might be some regulatory hurdles with respect to that. This is a question concerning distribution companies. There's a movement in the industry towards setting up distribution companies, which are, in effect, companies that are.

MR. MCCARTHY: In effect, it's an in-house general agency.

FROM THE FLOOR: Right. My question is GAAP related. If there's a distribution allowance that's paid from the manufacturing entity to the distribution company, is that distribution allowance deferrable? What if the distribution company is making a profit and earning allowances that are greater than the cost that it has for distributing the products?

MR. MCCARTHY: That would be novel, by the way.

FROM THE FLOOR: That gets into the whole rationale for distribution companies in the first place. I can't believe that the manufacturing side can sell the concept of profitable distribution to the distribution side, given that it hasn't been that way for 30 or 40 years.

MR. MCCARTHY: Your question assumes that these entities are consolidated, and they have the same GAAP reporting.

FROM THE FLOOR: They're all part of the same corporate family. The agents might be a minority or even a controlling shareholder of the distribution company, but it is part of a consolidated financial report.

MR. MCCARTHY: You know a funny result would be that the eliminations don't get you back to where you would have been without that. The logic doesn't always work.

FROM THE FLOOR: Yeah, I think it kind of gets to Dave Becker's comment about reverse tainting. Can I characterize something as a distribution cost just by virtue of setting it up in a distribution allowance?

MR. MCCARTHY: Yeah. It seems like the answer ought to be no.

MR. FRIEDSTAT: I've had some experiences, and I'm going to make an analogy. I think materiality is very significant here. I'm glad you clarified the question. I was going to assume that we were talking about a consolidated income statement basis, and not a separate company basis; that might have different implications. If you're doing a separate company opinion, you might get a different answer.

MR. MCCARTHY: The reason you say you might get a different answer is that, on a consolidated basis, these distinctions would disappear. Is that right?

MR. FRIEDSTAT: Exactly. However, the example I was thinking of, which is not too dissimilar to the one given, is this: a company pays an affiliate an investment management fee. In theory, the fee should roughly equal cost; however, sometimes the affiliate might make a profit on it. However, assuming that all of this is material, the affiliated manager—like the distributor—would only be allowed to defer amounts based on cost; the portion of the fee that represented profit could not be deferred. So that's something that you have to deal with. In some cases, we've actually gone to the extra work of making the adjustment where it wasn't material. You might be able to have some flexibility for lack of materiality. This does come up. It is something you should ask some of the distribution companies and the bigger companies with investment arms.

MR. MCCARTHY: That's a good point that is worth emphasizing. You might get different answers, depending on whether you are reporting and offering an opinion for the separate entities or for the consolidation. I've noticed that people care about the separate entities. Among other reasons, it might effect incentive compensation. People seem to be interested in that and pay attention to it.

MR. GEORGE E. HARRISON: We had a question earlier about supplementary contracts involving life contingencies. If the money comes from the proceeds of a life insurance policy, should it be valued using annuity standards? The answer was yes. The other question is, should the mortality table and interest rate used be applicable to the year when the supplementary contract was issued or should it be applicable to the year when the original life insurance policy was issued?

MR. DAVIS: I guess we felt pretty strongly that it should be at the time the supplementary contract comes into existence. The new money is lined up better. You could have a situation for a contract originally issued 15 years ago. You could have double-digit valuation rates there.

MR. MCCARTHY: I think he's on mortality now.

MR. DAVIS: It applies to interest and mortality, and that just doesn't make any sense today.

MR. HARRISON: Yes, I would agree with that. We had one company that saw it differently. The original life insurance policies were issued so long ago that the mortality tables were not conservative, but the interest rates were.

MR. FRIEDSTAT: The answer that you've given is certainly the answer in general practice. I believe Actuarial Guideline 9 gives you some choice. I don't want to make it appear like it's a fixed answer.

MR. DAVIS: Dan has Actuarial Guideline 9 right here.

MR. MCCARTHY: It tells us what an annuity is. I think we can handle that.

MR. DAVIS: Is it 9B that's stretching settlement mortality?

MR. MCCARTHY: Yes. There's weasel wording in here, which was intended I would say to leave some room for looking at interest rate yields in particular, which is what paragraph 9 of Guideline 9 talks about. It says that it's up to the examiner, so the examiner should apply kind of a "get real" test to be sure that things are working properly.

MR. DAVIS: This often comes up in the block of structured settlements that have been put on the books 10-15 years ago. Life insurers with non-life insurance parent companies were under extreme pressure in late 1993 when interest rates were at their bottom. We heard, "Sell everything you have." Why was that? It generates the capital gain and improves the parent's bottom line. So there are structured settlement books out there that have had a complete turnover of the asset portfolio. I'm an actuary for one that has a cash-flow testing reserve equal to about 6% or 7% of the liability. What it says in that guideline, if I remember right, is that for this kind of business (if in fact, the assets no longer represent yields available at the time the contracts were put on the books), you should be updating the valuation rates to today. It should match the valuation rates that existed when the assets were purchased.

I've read that, and I've heeded it, but I actually think the preferred approach is to continue to use a cash-flow testing reserve. It would be an additional reserve that reflects the actual assets you have and the actual cashflow. We do have old, outdated valuation interest rates, but we also have an additional reserve that kind of theoretically gets it to a current valuation interest rate level.

MR. BECKER: Mark, the only additional comment I would make on that is, one might be trying to decided between an add-on reserve because of reserve inadequacy testing or something different. This person should consider the tax impacts of changing the reserve basis in the policy.

MR. DIJOSEPH: I have a question about allocation. I don't know if there are any rules on this. When you have affiliated companies marketing a program that contains products from both companies, are there any guidelines or specific rules pertaining to how you need to allocate the marketing expenses of that program to the individual companies? I agree that in consolidation, it doesn't much matter, but from a regulatory standpoint, you could essentially use one company to finance the acquisition expenses of another.

MR. DAVIS: That's true if, for example, their response rates were very different, or your costs were very different. I was going to say use common sense, but that isn't always a good guideline in GAAP. The key is to follow a reasonable basis and follow it consistently. I think you get in trouble with these things when you start changing horses every year in response to how the numbers come out. That's when you really have a problem, not only from an audit point of view, but from any defensibility point of view.

MR. JAMES L. MCCALLEN: I have a question from the statutory side, and we know what the answer should be, but this is about a product that we're thinking of introducing. There's a front-end load, and then there's a partial expense refund for surrenders in the early years. Along with that, there's also a commission chargeback to the broker/dealer. It seems that after you apply Actuarial Guideline 33, you should hold an additional reserve for the refund. There's difficulty in getting an offset for the commission chargebacks.

MR. MCCARTHY: I don't think you get an offset for that under statutory accounting. That's Exhibit A for nonadmitted assets at best. Even if you assume you put it up, you're not going to get credit for it.

MR. DAVIS: The commission chargeback has been around a long time. They just typically don't go more than a year.

MR. MCCARTHY: That's right. Even if it is a contingent amount due from an agent, I don't know of any way to take credit for that.

MR. DAVIS: When statutory questions come up, you can often ask, "What's the worst possible thing that could happen?" That gives you guidance as to what reserve you should be holding.

MR. MCCALLEN: Does it make a difference as to whether the event that triggers this is essentially nondiscretionary because of the tax consequences to the customer?

MR. MCCARTHY: That doesn't bring the charge back in.

MR. MCCALLEN: No, but it could eliminate the need for holding an additional expense refund.

MR. DAVIS: You mean on the grounds that nobody would be foolish enough to do that or something like that?

MR. MCCALLEN: They would lose all the inside build-up on their policy if they were grandfathered.

MR. MCCARTHY: I would draw your attention to some tax cases in which that issue has been raised anyway.

MR. MICHAEL P. SPARROW: I had a question about what valuation guidance might be out there for funding agreements that are denominated in currency other than that of the U.S.?

MR. MCCARTHY: You are referring to the U.S.-domiciled company in a foreign branch?

MR. DAVIS: Here's a more prudent asset/liability management program in which they would have you swapping up those currency risks immediately.

MR. SPARROW: The issue is whether the swap asset is something you can consider within your statutory liability. Let's say you have a fixed rate liability in Euros. Suppose you've entered into a swap that completely puts that back into the U.S. dollar basis. You take those in combination for determining the liability; however, there isn't any guidance that says that's appropriate.

MR. MCCARTHY: I don't know of any guidance on that. I don't think the statutory hedge rules get you there. I don't know whether you could stretch anything from interest index annuities and the hedge rules. They certainly weren't written for that.

MR. KERRY A. KRANTZ: I don't have an answer, but I have a couple of things to share from which somebody might be able to create an answer. First, the statutory statements have to be in

U.S. dollars. Second, there's a new kind of asset that combines the replicated synthetic asset transaction. Maybe that is what he's talking about?

MR. DAVIS: I'm not sure what he meant by *the replicated synthetic asset*. We've entered into swap agreements that put our net liability on a complete U.S. dollar basis.

MR. MCCARTHY: The question is, can you get there?

MR. BECKER: The synthetic asset issue is a page-two item. In other words, if you've entered into a combination of agreements, the combination behaves in a certain way. You can look at it and hold it in a statement in that way. What you're saying is, "I have a liability in Euros, but I have an investment that will completely neutralize that situation." When both pieces are considered, it's all in U.S. dollars. Why should you have any complex issues or any penalty under statutory accounting as a result? I'm not saying that you couldn't do it, or you shouldn't do it. I'm not sure how to produce the chain if someone wanted it.

MR. MCCARTHY: One of the questions that sometimes comes up is whether the asset structure that you have runs for the full duration of your contract. Sometimes it doesn't.

MR. BECKER: That's a more serious view.

MR. BECKER: If you really had something that totally took it out of Euros and put it into dollars perfectly over the horizon of the product, you'd be hardpressed to say you have a foreign exchange problem.

MR. DAVIS: Think about the nitty gritty aspects of statutory accounting. You have the currency hedge book with the market value. Isn't it essentially being held at market? If you don't put the liability in Euros, the two won't sum to the right number. It's one of those situations where you really have to do two things to get one point.

MR. MCCARTHY: If we go back to the point that was made before about the statement being reported in U.S. dollars, you would wash everything else through the foreign exchange adjustment.

MR. BECKER: I think Mark is right. You might be able to get there, but you'd want to be paid by the hour to explain to somebody how you got there.

MR. MCCARTHY: This is spoken by somebody who told me he's entering the consulting field.

FROM THE FLOOR: On equity-indexed annuities, an increase in reserves for any particular year is linked to some equity index. As far as completing page 7 on stat, what common practice is being used to calculate the tabular interest?

MR. MCCARTHY: I don't know the answer to that. When I have unusual kinds of things on page 7, I try to find out what has to make sense so that the top line or the bottom line relate in some reasonable way. I would assume that you'd be looking at the experience that drove that reserve increase. I do not intend that to be a precise answer. I've always found page 7 to be very useful way to analyzing some kinds of contracts. You might know what it has to look like, but how do you get there? That's the best starting point. I'm old enough to remember that it used to be page 6.

MR. BECKER: I've been around long enough to have heard a lot of people ask why it even still exists in the statement?

MR. MCCARTHY: We have a few closing observations.

MR. BECKER: There were some items that we thought would be useful to share with you folks. The year-end work will be pretty grueling. Remember that codification goes on line in 2001, and your quarterly statements will have to be prepared accordingly. If you don't have the processes and procedures in place to provide additional information required by codification, this would be a good time to begin working on that. I was on the receiving end of that for quite a few years. When you think you're ready to slack off a little bit, you'll just be moving from one fire to another fire.

MR. MCCARTHY: We also talked about the fact that, in the long run, codification might help reduce the number of multiple opinions that people have to prepare (depending on what specific states do about it), but in the short run, it's probably worse. This year-end could be as bad as any. There are XXX states, non-XXX states, and codification is looming. We thought that the issue of different items that have to be adjusted for different opinions might be as bad this year as ever or even worse. We're about to get a regulatory comment that might either confirm or challenge that statement.

MR. KRANTZ: This is just a reminder of our first quarter. There's a new health blank that's going to also be used during the first quarter of 2001.

MR. MCCARTHY: We talked about the C-3 requirements for this year.

MR. DAVIS: Right. I think it's easy to forget that. The risk-based capital statement C-3 calculations are in effect for the 2000 year-end. We'll have to do some additional scenario testing. If I've read those requirements right, then I would say that most companies will have to do that. You have to look at the surplus position at every period for every scenario over the 30-40 year projection period. So there's some additional spreadsheet work that will have to be set up. I don't think anybody's projection system is just automatically producing all those values, because it's kind of a CARVM-approach that depends on what the scenario result is. Take the present values and use the worst one. There's some additional leg work there that will be coming up.

MR. THOMAS A. CAMPBELL: Just a comment on Mark's point. Before you do all that work, there are two exemption tests. The thought is that many companies will either pass or fail depending on how you look at it. Some might not have to do all the testing. These are things that you can look at today that pertain to estimates. We did the exemption test at our company, and we were very far away from having to have to do this testing. It saved us a lot of time and preparation.

MR. MARTIN R. CLAIRE: One thing has been lost with all the focus on the 50 scenario testing and the C-3 testing. There's another requirement in there saying you have to hold 50% of the difference between what the value of the asset is on your book and the callable asset. For companies that, in effect, have exemptions, it's worse, because they have to do this test for all assets that aren't subject to this new 50 scenario testing. So you might leap for joy about not having to do the 50 scenarios. This means more assets are going to be covered by this 50% RBC for the difference.