

# 2004 Valuation Actuary Symposium\*

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## Session 6OF GAAP Issues

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*Summary: This open forum addresses current issues of interest to actuaries in the application of U.S. GAAP. Experts in the application of GAAP to life insurance companies lead discussions on the theoretical and practical aspects of these topics and other emerging issues.*

**MR. CRAIG W. REYNOLDS:** Most of the topics that we'll be covering today are addressed elsewhere in Val Act in some depth with dedicated sessions on those topics. So, much of what we'll do today will be an overview of these individual topics, and we'll leave some of the details for the later workshops and sessions. You'll have to forgive us if we don't get into enough depth on any one of these. Each of them could merit its own session.

I'm going to be talking about Standard of Practice (SOP) 03-1 and, to a lesser extent, about international accounting standards (IAS). I'm going to start by giving a brief overview of SOP 03-1, and then I'll move on from there to talk about some of the interesting theoretical and practical issues that we've encountered in helping clients comply with this. In particular, Milliman is in the process of wrapping up a survey that we did of a dozen or so companies to talk about how they have resolved some of the open issues related to interpretation of the SOP. I'll talk about that a bit as well.

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**Note:** The chart(s) referred to in the text can be found at the end of the manuscript.

As we know, the SOP is about the accounting and reporting by insurance enterprises for certain nontraditional, long-duration contracts and separate accounts. It was issued in 2003 by the American Institute of Certified Public Accountants (AICPA), and it's effective for fiscal years beginning after December 2003. In theory, all of you have already implemented this. It seems pointless to talk about this topic since it's done. I still feel that it's a worthwhile topic to address, however, because there are a number of areas where practice seemed to be divergent and inconsistent from company to company, and it'd be interesting to talk about a few of those topics. We'll be talking about the client survey we did related to that.

First, there is a brief summary for those of you who may not have been involved in the SOP implementation. Some of the parts of the SOP are more accounting issues; some are presentation issues; some are disclosure issues; and, yes, there are even a few actuarial issues along the way. I'm not an accountant. I'm an actuary, so I'm going to skip most of the accounting-related issues. I don't really care much whether something has separate account or general account presentation. The reserve and deferred acquisition cost (DAC) issues are the most interesting to me.

Generally speaking, the regulation requires that for multiple account value products you hold the highest account value as the reserve. We implemented some new rules to require extra reserves generally for products that have profits followed by losses on certain insurance benefit functions, most commonly no-lapse guarantees on universal life (UL) and variable universal life (VUL) plans, guaranteed minimum death benefits (GMDBs) and related benefits on variable annuity (VA) contracts. Secondly, there are also products that have extra favorable annuitization guarantees. There'll be some extra GAAP liabilities for that and some accounting for bonuses and sales inducements.

I'll talk first about the front-loaded products with back-ended benefits. Generally this comes into play most often with features like GMDBs on VAs and no-lapse guarantees on UL and VUL plans, as well as levelized or reverse select and ultimate cost of insurance (COIs) on UL and VUL plans. Without going into too much detail on the methodology, generally speaking, the rules require you to set up a reserve that's funded as a level percentage that they refer to as the benefit ratio of the assessments on the contract. This is very similar to the way the DAC calculations work, except there the levelizing method, rather than being the assessments on the contracts, is estimated gross profits (EGPs). There is a small difference between the two, but, generally speaking, they're there. Once the extra reserves have been determined, we need to calculate the impact of that on the DAC as well where there are some changes in the DAC related to taking into account the extra SOP reserve and its effect on the EGPs.

When we surveyed our clients, one of the things that we were most interested in was the SOP's business impacts. Is this just a financial reporting hoop that we jump through, or did it actually change the way companies were operating? The

answer seems to be that there are very few impacts. I don't know if in our survey we encountered any company who has actually done product repricing specifically because of the SOP. Certainly when they go to reprice or introduce new generations of products, they do take SOP 03-1 reserves into account, but that was not the sole motivation.

Largely that was because many companies are pricing solely on a statutory basis or using some sort of economic reserve that in some cases the economic reserves already took into account something resembling the SOP 03-1 reserves. One area where we did see a fair amount of practice change was related to sales inducements. There are a lot more accounting-related disclosures and policyholder disclosures going on in terms of clarifying exactly what portion of the credited rates, for example, really are bonuses, as opposed to just naturally expected trends in rates.

Excess annuitization benefits work very similarly to the front-loaded, back benefits situation. I haven't seen this being a huge issue for most of our clients in the United States, although it is starting to be an issue in Japan. We see it a fair amount with some of the fixed annuities that are offered there with the long-term interest guarantees. I was just handed by one of my fellow panelists a new practice note, in effect, from the AICPA on this topic. This did clarify to me, based on my quick, 30-second read, that this part of the rule does apply to traditional style, old fixed benefit annuities, which probably few companies here have, but that'd be one area that Japanese companies have been struggling with. It wasn't clear if the rule really even applied to them, but they seem to have clarified that now. Sales inducements, again, are subject to the SOP, and, again, levelized through the mechanism of this.

Now we start to get into some of the more interesting practical issues related to this. In order to do the reserve mechanics, the SOP states that an insurance enterprise should consider both frequency and severity under a full range of scenarios that considers the volatility inherent in the assumptions. There are a lot of unclear issues related to that. One is: How many scenarios are enough? How do you generate those scenarios? Should they be stochastic? Should they be deterministic? Are they simply economic scenarios or also policyholder behavior scenarios?

We found a few interesting things when we talked to companies in terms of what they're doing. First off, among the VA products, most of the companies we talked to are doing this on a stochastic basis, but there is quite a variation in terms of the number of scenarios that companies are using—from 100 up to 10,000 scenarios. Interestingly, when looking at the VUL and UL products, it's much more common to do it either on a deterministic basis or with a sampled set of stochastic scenarios where they generate a large number of scenarios and map it into a smaller set for testing. I believe all the companies we talked to used 100 or fewer scenarios for the VUL and the UL products.

When we talk about the scenarios that companies are using, some of them are using internally generated stochastic scenarios that might have been generated by their asset-liability modeling (ALM) function for use in ALM analysis already or a pricing process. Some of them are using the C-3, Phase II, risk-based capital (RBC) scenarios. Others are using, in some cases (particularly for the VUL and UL), judgment-based deterministic scenarios. There are a number of companies out there using a mean reversion methodology for doing their scenarios in DAC calculations, but there didn't appear to be much use of that in the SOP 03-1.

Looking at things that vary across those paths, obviously economic returns are one of the things that vary. Most of the companies we talked to are using formula-driven policyholder behavior, lapse or benefit election functions, but few of them are actually testing scenarios of policyholder behavior. The policyholder behavior is changing as a function of the scenario but not in isolation, which was a little bit surprising to me. I would have expected at least lapse rates to be something that companies might be stress-testing.

One of the other interesting things that we've talked to companies about is discounting rate. What rate do you use to discount across the scenarios? We found that just about everybody that we talked to is discounting everything at the DAC interest rate, and rather than using the average ratio, they are, as the practice note suggests might be appropriate, taking the average benefits divided by the average assessments to come up with a ratio. Those averages are generally being computed using uniform weightings, so all scenarios get the same weight.

One thing I was curious to find out is how often companies are going to go through the work to do benefit ratio determination. I've forgotten the exact wording in the SOP, but I believe it says "regularly update." It appears that the most common interpretation of that is to do so quarterly. At least one bold company out there said it was going to do it monthly, and I respect them for pulling that off with that kind of frequency. We didn't talk about the mechanics of how people are getting this done in short financial reporting cycles, but I'm going to presume for the moment that most of them are using early data, data from the prior month; otherwise I'd be impressed if they can pull it off within a normal financial reporting cycle.

Granularity is also an issue. At what level of detail are these calculations being done? We found that most companies are using something approximating the same granularity that they use for their DAC calculations. Generally speaking, the extra reserves have to be floored at zero. Those floors are also being done at that same level. A few of the companies we were talking with have not dealt with unearned revenue reserve at all. It didn't apply to their products.

There are a couple of interesting issues with no-lapse UL products, where we found a huge divergence of practice. One is in the definition of assessments. I generally think of assessments as the charges against the contract, interest spread plus COI charges, plus expense loads, etc. After an account value goes negative on a UL

product, which it will at some point on some scenarios for many of these product designs out there, it's unclear what you should use for your assessments. We found a variety of practices. Some companies are using the no-lapse premium itself, the minimum premium paid as the assessments once the account value goes negative. Others are, in effect, ignoring the fact that the account value goes negative and using the expense loads and COI charges as if they were collecting them. Obviously you can't collect money from a negative fund, but they're still doing it. Some are just setting the assessments to zero once the account value goes negative.

The benefit definition is also interesting. One can make an argument that by a literal reading of the SOP, you should be using the death benefit paid minus the account value released at death in all time periods. In talking to my fellow panelists here this morning, I believe it's true that they agreed with that as the general benefit definition.

**MR. DAVID C. SCHEINERMAN:** It depends on whether you have a no-lapse guarantee or not.

**MR. REYNOLDS:** We found some companies that are doing that. Other companies are saying that in a no-lapse guarantee product they'll only consider the benefits to be zero until such time as the fund goes negative, and then they'll say that the full death benefit is the benefit that goes into the calculation. Other companies are using the waived charges, the charges that they should be collecting but can't because the fund value is negative, as their benefit in that scenario where there seems to be no commonality of practice on a number of these issues.

Let's talk about some IAS-related issues. Again, there are a number of sessions here at this meeting on IAS, so I'll be giving a general overview of IAS status as I understand it. This is not an area of special expertise of mine, but I've done some work in this area. Generally speaking, IAS is moving us toward fair value accounting. Phase I is effective year-end 2005 for companies listed in the EU. For Phase II, who really knows? Some of the dates being talked about are not until 2007 or 2008, but a lot of people I've talked to who are involved in this believe it's going to be significantly later than that.

So why are we even talking about IAS here in a session that's all about GAAP? There are a couple of reasons. As we'll talk about a bit later, the Federal Accounting Standards Board (FASB) may be moving the GAAP standards to look a lot more like IAS in the future. So GAAP and IAS may be converging, although it's going to be a slow process. Secondly, in a lot of companies that we deal with, the same staff that deal with GAAP are also dealing with IAS. To the extent that's true, either now or in the future there's no doubt that you're going to end up spending a fair amount of effort in reconciling GAAP and IAS earnings. The FASB is working with IASB on developing some position papers on what fair value means, so it's highly likely that we'll have some convergence down the road within a few years on that topic.

What does fair value mean? It means assets and liabilities get marked to market. Since we don't have a readily determined market value for liabilities, we have to use analytic methods to determine it, and we'll use methods that are similar to those used to value derivatives, meaning multiscenario testing, discounting, present values, etc. There is considerable room for judgment in that exercise.

In Phase I, though, we're not fully moving to fair value. Generally speaking, what we have to worry about are investment contracts that have embedded options. Those options need to be valued at fair value, but the underlying host investment contract can optionally be fair-valued or held at amortized cost at company option. Investment contracts are those that have generally virtually no insurance risk. Things like an annuity certain, for example, would be a definition of an investment contract, but relatively few other examples of that exist in the United States. Insurance contracts and basically everything else will generally follow local GAAP, which in the United States is GAAP as promulgated by FASB and IAS.

For Phase II, we'll be looking at all assets and liabilities moving toward fair value. What are some of the issues we're going to deal with on IAS? One that's been generating a lot of controversy is the mismatch between assets and liabilities in that the assets generally are marked to market, and liabilities are, at least generally speaking, not. I am going to talk about surrender value, floor, discount rates, etc. The mismatch issue is that, generally speaking, a significant portion of assets will be marked to market even in Phase I, whereas very little on the liability side will be. It's not all that different from the way current U.S. GAAP works, but it's troubling that that's continuing into IAS.

The second issue is whether to floor reserves at the cash value. Certainly that's something that in the United States on a statutory basis companies are well familiar with, holding that sort of a reserve. It's been an issue of some contention through the IAS process, though, and in some ways it harms the integrity of a true fair value calculation. It's certainly unreasonable to have a surrender value floor if you're trying to do fair value, unless you really believe everybody's going to surrender, at which point the surrender value would be the appropriate reserve.

Discount rates are another interesting issue. Most would argue that discounting should be done in calculating your present values at an implied risk-free rate plus a spread, but it's entirely unclear what spread to use. One methodology would be to calibrate spreads to the recent issues. For example, on a single premium deferred annuity (SPDA), you could look at the market value as of issue and say it ought to be equal to the premium less the acquisition costs paid at issue and calibrate a spread to that. But that can result in some interesting situations and incomparability from company to company where a company that has more aggressive pricing can end up with lower reserves, which in some ways is problematic. Spreads can also be tied or developed in relation to the cost of capital, but then companies with higher credit risk get lower reserves, which again is somewhat unappealing, although it might be theoretically appropriate, arguably.

Another interesting issue is asset/liability separation. Generally speaking, if you want to determine the market value of some liabilities, you'd like to be able to separate it out from the assets. It's problematic for products with portfolio credited rates or dividends.

Some of the big challenges we're seeing include computer capacity. Related to that issue is, if we look at the countries where IAS is generally being pushed forward, predominantly the European countries, many of those countries work not from a modeling-based methodology but from a seriatim valuation system structure. They're used to doing their forecasts on a seriatim basis over there, and doing the multiscenario market value calculations that we're talking about for IAS on a seriatim basis is exceptionally challenging.

Most companies that are out there in the United States have fairly good actuarial models that may be suitable for this sort of calculation, but they have to be adopted to work in real time in order to do these valuations. While it may be possible to develop a model to do valuations in a timely manner, developing a model to do forecasts where we can forecast future earnings with what's been referred to as stochastic-on-stochastic analysis so you can do future IAS reserves during a projection of earnings can be quite challenging.

Practical challenges include staying current on what's going on, especially when there's a lot of uncertainty about what's being developed. Another challenge is disclosure requirements. The IAS standards are going to require a lot of sensitivity testing and disclosure-related implementation.

Phase I is going to require quarterly loss recognition testing. Most companies that I'm aware of that do U.S. GAAP do do loss recognition testing, but it's rarely done with quite that frequency. Under IAS, it will be required. The loss recognition testing does also have to take into account the options embedded in the products, so it's not just a single scenario best estimate loss recognition testing. It would be done typically on a multiscenario basis. Assumption selection, as always, as with cash-flow testing and the other areas we've been talking about, is a challenge. How many scenarios are enough? How do you make assumptions dynamic? How do you deal with asset/liability interaction? How do you choose discount rates, etc.? I think we're going to find that as companies adopt IAS, there's a fair amount of inconsistency from company to company.

There are a few background documents that are out here. For those of you who are not up to speed on those issues and want to get up to speed, the IFRS 4, I believe, is the one that's most recently come out several months ago. It is very helpful for understanding this material. IFRS 4 did clarify a few things. The definition of insurance risk was somewhat broadened to say that it must be a significant insurance risk, rather than just more than trivial. That has to do with the classification of insurance versus investment contracts. Embedded options on loss recognition, which I mentioned a minute ago, do allow for clarifying IFRS 4 that

there's an option for recognition of changes in interest rates on liability valuation that takes care of some of the mismatch issues. Also it suggests that in Phase II there will be no profit recognized at issue, so we can't result in a situation where the market value is significantly less than the premium you've collected for your liabilities. Notice that does not say no loss at issue. It just says no profit. So that doesn't necessarily mean calibrated to zero profit.

There are other hot issues going on. The FASB is getting involved in the fair value definition, as I mentioned earlier. The European Union has talked about adopting a modified version of IAS 39. The Chief Financial Officer (CFO) Forum has released a statement of embedded value principles, which is arguably not very relevant here, but I view that as an attempt by them to, in effect, codify or standardize embedded value and put more emphasis on embedded value as a reporting methodology rather than IAS standards.

**MR. SCHEINERMAN:** I'm going to cover three topics: FIN 46, the proposed SOP on internal replacements and an overview of FAS 133 with a bit of a focus on DIG Issue B-36.

The first one is FIN 46, and I'd like to get a sense from this group as to how many of you are familiar with FIN 46. It looks like a few. How many of you have had to deal with it? Not very many, and that's not surprising. FIN 46 is actually not much of an actuarial issue. It's more of an accounting issue that's important to your management or to your clients. It's one where actuaries can be helpful in the decisionmaking path around it, but you're not going to get involved in particular actuarial calculation or determination of balances.

I want to help you be familiar with it so when people are talking about FIN 46 you'll understand what it is about. What are the main things that you should know about it from a general business perspective? I'll provide a little bit of an introduction, talk about the consolidation accounting model. This is the provision of U.S. GAAP that requires a company to consolidate certain subsidiaries or certain operations into the overall financial statements. How do you apply the accounting model in the FIN 46 world?

I'd like to talk about the timing of FIN 46. The story began in early 2002, and I would expect most of you would remember the impetus for this. This was in the post-Enron period when Enron ran into obviously significant issues with the use of special purpose entities (SPEs), which were not part of their consolidated financial statements. The FASB launched this project to look at SPEs and when they should be consolidated and when they shouldn't. Then they broadened it to look more generally at the consolidation model. The existing accounting literature was a voting interest model. If you owned most of the voting rights to an operation, then you consolidated it; if you owned a minority, you probably didn't consolidate it. This led to, in 2003, the FASB promulgating FIN 46, and within a year they had to update it with FIN 46R, given the complexity and some of the implementation



issues that occurred. This is a pretty complex standard. I'm going to give you highlights on it, but by no means will any of us walk away as experts here. I hope it will make you somewhat conversant.

One of the things to be aware of is that FIN 46 is not just dealing with SPEs. It deals more generally with consolidation rules, and it can apply to any legal entity, even a fully functioning operating business that could then be subject to consolidation.

Next I'll discuss the accounting model. Under GAAP, an entity must consolidate any entity in which it has a controlling financial interest. That means that the assets and liabilities of that entity become part of the consolidated financial statements, and that's particularly important if that entity has been financed with significant debt. It would affect the apparent operating structure, the capital position of the consolidated parent. It also would affect the reporting of revenues and expenses.

The longstanding accounting model, as I referenced before, was that you consolidate if you own more than 50 percent of the entity's voting interests, but FIN 46 made two changes to this. It said the voting interest model really isn't necessarily defining what a controlling financial interest in an entity is. It defines when a company should use the controlling financial interest as the method for determining consolidation rather than voting interest rights. In determining and analyzing this controlling financial interest, they defined this new risk and rewards model, which is an area where actuaries may be able to assist your accounting brethren in understanding the economics of these situations and who has the risks and rewards. The kind of situation where you might end up bumping into this is if a company is looking to get some relief on, for example, its XXX reserves. They set up a subsidiary reinsurance company, and then they raise capital through the capital markets, preferred shares or notes within an entity. Is that special purpose reinsurance company consolidated or isn't it? There are other structures with special reinsurance companies where you might bump into FIN 46.

The two accounting models that FIN 46 now outlines are the voting interest model (which was the traditional model, if you own more than 50 percent), but in order to apply that you first have to determine whether the risk and rewards model or the variable interest entity (VIE) model applies. I'm going to get to that.

The accounting model has two steps. First, you determine whether it is a voting interest or a VIE. To be a VIE, you possess one of those situations. The entity might be thinly capitalized. You might set up a subsidiary with \$100,000 of capital, but tens of millions of dollars of assets and liabilities are being financed through preferred stock or other debt. So with the thin capitalization of \$100,000 that this legal parent might have, does that really make sense that they are the ones who consolidated or is it really those external note holders who should consolidate it?

Who controls the entity? If that equity owner has a couple of million dollars equity in it, but they're not really controlling the entity, then there's probably a variable interest model, and you should look at who has the risks and rewards of the entity rather than just going with the voting shares. You should also consider if those equity holders don't totally participate in the residual economics or if there is non-substantive voting interest. Those are some of the criteria, and it takes a fair amount of analysis to determine if the situation fits into one of those. But if it does, then you follow the accounting model for VIEs rather than go to the voting model to determine who consolidates.

In determining the primary beneficiary, again, if it's a voting interest model, majority of voting interest consolidates. If it's a VIE, then you look at which party has the majority of its risks and rewards with the VIE. The FASB introduced some terms that are specific to FIN 46 around expected losses and expected residual returns. Expected losses doesn't necessarily mean out-and-out GAAP losses. It could be losses or returns below what's expected. Who is subject to the main variability and returns? If you're in a VIE model, the one who is subject to most of the variability and returns is likely to be the entity that's going to consolidate.

With FIN 46, the myth might be that voting control is still the primary determining factor in consolidation. That's not the case. If it's a VIE, you look at who has the majority of the risks and rewards with the entity. Some of you may be familiar with FAS 133 where there are grandfathering provisions. In FIN 46, not only are there no grandfathering provisions, but also an entity that might initially be consolidated might become nonconsolidated later on or vice versa.

The effective dates for these accounting pronouncements were basically for fiscal periods starting this year, so your organizations should have been subject to it with no grandfathering. In addition, the financial statements allowed a significant amount of disclosures relative to these situations, and it is a pretty complex pronouncement. Hopefully this gives you an overview of the basic principles of FIN 46. Again, I think where the actuary can play a role is in working with management and the accountants in understanding the structure of these kinds of situations, what the economics are, interpreting them and helping to figure out how the accounting model applies.

We'll move on to the SOP on internal replacements. This is where I would expect actuaries to be considerably involved. There are interpretations that need to be done that actuaries can be helpful in, and then there are implications on DAC and GMDB liabilities. I'm going to cover the existing GAAP guidance, and we're going to talk a little bit about the draft of the proposed SOP.

The existing guidance in GAAP currently is in FAS 97. FAS 97 was promulgated to address nontraditional life insurance contracts like UL. At that time, it addressed what happens if you have a traditional life insurance company that is exchanged to become a UL insurance contract. FAS 97 clarifies that you write off the DAC. You

treat the exchange as if it's a termination of the FAS 60 contract, the traditional term or whole life insurance contract. With the new UL contract, you account for that prospectively. If there are conversion costs or other implementation and acquisition costs for the UL contract, you would then set up DAC for that.

Practice Bulletin 8 came along to try to help interpret and help practitioners with some of the nuances of FAS 97, but they punted on helping relative to this internal exchange. They basically said that FAS 97 talks about traditional to UL contracts and other situations depend on the circumstances of the transaction. So if you have a fixed annuity that goes to a VA, that may be unclear as to whether that is a replacement. Can you just account for that as a continuation of the contract, or do you have to treat it as if it's a lapse and a new issue?

The basic principles of the SOP are as follows: If this internal replacement occurs, and the rights and obligations, the substance of the situation, is substantially unchanged, then it should be accounted for as a continuation of the existing contract. You continue to include that contract in the cohort that's being used for DAC amortization. You continue to include it in unearned revenue reserve calculations or additional liabilities for the SOP. But it also defines what an internal replacement is. This is important because with the lack of specific guidance from FAS 97, that by itself lends itself to diversity in practice, which is why these SOPs get issued, to try to reduce the level of diversity in practice.

You also might have diversity within the same company. In one situation you might amend a contract and view that not as an exchange, but in those situations, maybe because of the state requirements, you have to issue a new contract, and that's considered an exchange. The SOP says that it doesn't really matter what the legal form is. If it's a new contract, an amendment or an election of a rider or a feature, then that's an internal replacement. Then it talks about if you meet certain rules, these internal replacements can be accounted for as a continuation of the contract, but if it doesn't meet those rules, then you have to treat it as a lapse or a termination and then the issuance of a new contract.

For a contract to be considered substantially unchanged, it outlines several rules. There is a decision tree that you have to go through. First, the insured event of the contract can't have been changed. If you have a contract that currently provides a mortality benefit such as a death benefit, and then it converts to payout annuity, which is also a mortality risk, that's really a different type of insured event going on. Or maybe it goes from life insurance to a long-term-care (LTC) type contract. If you have a change in the insured event, then it's not considered substantially unchanged. It is substantially changed.

The nature and the investment rights, if any, have changed. If you have a contract that's an SPDA, a fixed annuity, and it's exchanged to an equity-indexed annuity (EIA), the nature of the way the policyholder gets investment results will change. That's not substantially unchanged. Another item that would cause it to be

considered substantially changed would be if you required an additional premium or there was a charge or underwriting relative to the exchange of that existing contract to a new contract. Another consideration is changing the participation or dividend features, or if there's just a change in the amortization method or revenue classification. What they mean here is you know how with insurance accounting you have to classify your product, be it FAS 60, FAS 97, FAS 120. If the exchange leads to a change in the product classification, then, again, it would be considered substantially changed.

If you have a contract that is substantially unchanged, then you can just account for it as a continuation of the replaced contract. You don't write off the DAC that exists; you continue to preferably include the EGPs or the gross margins in the DAC amortization, preferably included in the existing cohort that you've been accounting for that contract. But if it's not practical to do that, the proposed SOP does allow you to start over, basically transfer the balance associated with the contract that got exchanged and then amortize it going forward. There are a lot of implementation issues that we're all going to have to figure out, not the least of which is simply identifying contracts that are exchanged and then figuring out how you're going to account for them. This is an area where we'll learn over time as to when and how it make sense to move the contract into a new amortization process with an existing balance versus keeping it the way you were amortizing it before, the DAC balance. But it's not just DAC. It's also unearned revenue reserves or SOP-type liabilities.

Within the proposed SOP, it also provides some good examples to understand some of the implementation issues as to whether something is substantially changed or not. It clarifies, for example, that if there's a rider within the contract that was part of the contract when it was issued, and there was a set price for it, then the election of that rider does not result in it being an internal replacement. It's not substantially changed. For example, if you have a VA that's issued with a guaranteed minimum income benefit (GMIB) rider at 45 basis points, but the policyholder doesn't elect it initially and later on they elect to take the GMIB rider, that's not substantially changed. However, if you have existing VAs without a GMIB rider, and then later on you amend the contract to allow for the rider, then that would be substantially changed.

It also talks about whether some of these riders are integrated benefits versus not. An integrated benefit would be the addition of, say, a GMDB rider on a VA. That GMDB benefit will vary based on the base contract. So it's clear that it's one integrated contract. But if you had a VA, and you added an LTC rider with a set premium for a set benefit that was independent of the annuity, then you would account for that LTC rider on its own and not consider the contract as substantially unchanged.

That gives you a sense for it. The good news is that we don't have to deal with it this year. It's likely to be exposed. FASB just last week unanimously approved

having the Accounting Standards Executive Committee (AcSEC) re-expose the proposed SOP, and the AcSEC also endorsed it. I expect it's going to be out in the next few weeks, probably September, October or maybe November. You will all have a chance to comment on it. I'd encourage you to look at some of the administrative implications, and then prepare to deal with it probably beginning in 2006.

Those are some comments about the SOP. On FAS 133, this is another very complex pronouncement. I'm going to try to cover the basics pretty quickly, and then I'll talk a little bit about DIG Issue B-36. I don't think any of us have all the answers to it, but it has been an interesting period when people have been trying to figure this out and apply the principles there.

FAS 133 is basically about derivatives, providing accounting guidance on derivatives and making it principles-based rather than definitional. It's not because something's called a derivative. It's not that something's labeled an option or a future. It's really more about what the underlying characteristics of this financial instrument are. There are a few criteria. There needs to be an underlying with a notional amount, and an underlying might be the Standard & Poor's (S&P) 500. It might be a contract that will provide the return of the S&P 500 index, and the notional amount might be \$100,000 or some amount. The investor is not purchasing \$100,000 worth of the S&P 500; they're instead putting up a notional amount. But they get the full return of that S&P or it could be interest rates or it could be the basket of goods, commodities, etc. So it's a limited initial investment. You're not putting up the whole notional amount, and the benefit is net settled; i.e., it generally can be immediately settled in cash or converted to cash rather than paid out over an extended period of time.

Those are the situations that are going to look and smell like a derivative and most likely be accounted for that way, but they did give us a nice pass on insurance contracts. If you have a life insurance contract where the benefit is indexed to the S&P 500, and it's a death-benefit-oriented benefit, then it's an insurance contract that's exempt from FAS 133. But within an insurance contract, you still might have what are called embedded derivatives that are subject to FAS 133 and might need to be fair valued. The basic guidance of FAS 133 is that, once you've identified these derivatives, you need to account for them at fair value on the balance sheet and have the changes in fair value go through earnings.

There's also a significant focus in FAS 133 on hedge accounting and what situations you can't have hedge accounting and what happens if you do. You'll get a nice match in between what's going on on the asset side and the liability side. One example of that presumably would be if companies are hedging their GMDB liabilities with derivatives, if the derivatives are going to be carried at fair value, you would want to be able to account for the GMDB liability at fair value, have a nice match, or somehow account for the assets at more of a book value, and let the change in fair value go through other comprehensive income (OCI). The challenge

is that in the details of FAS 133, in order to get hedge accounting, it needs to be a mix of similar assets or liabilities that you're hedging, and since VA policyholders are all different with different fund mixes, different in and out of the money, I'm not aware of situations where people have been able to get hedge accounting for hedging GMDB. But FAS 133 is where you look for the guidance to see if you can fulfill the hedge accounting.

Within FAS 133, as I alluded to before, it also defines embedded derivatives. These are elements of a financial instrument that are within another instrument. It's a hybrid instrument where within it you have a derivative that you need to carry at fair value. A good example of that would be an EIA. You have an annuity that's going to guarantee perhaps a 3 percent return as the minimum rate of return, but you also have the opportunity to get the participation that's linked to the equity markets. Within that contract, there's the embedded derivative of the indexing, and then there's the host contract with just the basic guarantee returns. Or you might have an equity-indexed UL insurance contract where you look at a life insurance contract, and that's primarily a death benefit, so you think it's exempt. But if that account balance will get interest credited based on the equity index, you probably have an embedded derivative that would need to get bifurcated at fair value.

The criteria are if the contract as a whole is already at fair value, then you don't need to look within it. First, is the contract not carried at fair value? Is that feature within the contract a derivative? And is that feature clearly and closely related to the host contract or not? An example of "clearly and closely related" would be that an interest rate index is viewed as clearly and closely related to a debt instrument, whereas an equity return would not be clearly and closely related to a debt instrument.

There are some grandfathering provisions for FAS 133 that some folks have been able to take advantage of, keep some contracts from having to apply it. Obviously if you amend an existing contract, then you taint it, and you have to apply FAS 133 to the amended contract.

FAS 133 is complex. There was a group called the Derivative Implementation Group, which many of you are probably familiar with, that issued various guidance elements, and there are some insurance-specific ones. That's a good place to look for guidance on specific insurance issues.

B-36 came out last year. In certain modified coinsurance (modco) reinsurance arrangements or funds withheld, what the FASB identified is that the underlying economics are such that the typical assuming company has loaned back the balance to the ceding company, and that ceding company is going to grant interest on that loan based on the underlying securities being the assets, the investments supporting that loan. Because there's an underlying of that basket of assets, and that's what's going to cause the investment return, that's the derivative, and it's not clearly and closely related to that debt host deal. If an entity borrows money, if

it's a fixed interest rate or an interest rate perhaps tied to a Treasury index, only its own credit risk is related to that loan. But if the interest that's being indexed is unrelated to that entity's credit risk, then you have a situation where there's a derivative.

The reason modco arrangements are considered embedded derivatives requiring bifurcation is because of that return that's unrelated to the creditworthiness of the borrowing entity, the ceding company. The reason modco agreements generally have that provision is because in order to get statutory reinsurance credit, you need to pass along all the risks of the underlying liabilities to the assuming company, including investment risk. They came out with this DIG issue, the guidance, but they didn't really tell you very much about how to apply it, and it is pretty complicated in terms of what's really going on.

They did say that you need to make it related to the facts and circumstances of the arrangement. They did say that if you have a ceding company and an assuming company, it's not necessarily required that they interpret the guidance and come up with the same fair value for that arrangement, which I guess is helpful. As companies have looked to interpret this, in general people are viewing it as a total return swap where, again, the assuming company has loaned the money to the ceding company perhaps at a fixed interest rate, and the ceding company guarantees to provide the underlying return on the assets to the assuming company. It's that interest rate swap that people are looking to fair value.

Some of the guideposts are that at time zero you would expect this embedded derivative to have a zero fair value. As you're valuing this derivative, the common formula that I see people using is that you look at the market value of the assuming companies' assets versus the book value and how that changes each period, and you look at the market value of the liabilities that are associated with that loan and how they've changed relative to the book value.

One of the things that I think is really important about this is that it's not entirely clear how to apply the guidance. However, once you have defined it within your entity and applied that model objectively and consistently, that's what people are going to be looking for in terms of expectations. There are two typical approaches. One is what I call a variable interest approach, where you view that loan as a variable interest loan. The assuming company has lent it to the ceding company at a variable rate tied to London Interbank Offered Rate (LIBOR) theoretically. For that kind of a loan, if it's a floating rate loan, the book value and market value of that liability will always be the same. So the change in the fair value of this embedded derivative will simply be the change in the value of the market value of the assets relative to the book value of the assets.

There's also a fixed interest approach, which is more complicated to apply, where it's viewed as a fixed interest rate loan for probable duration of the liabilities. What that will capture is when you're doing the change in the market value of the assets,

you'll be valuing both interest rate changes and credit rate changes. When you're doing a change in the market value of the liability side, that'll probably capture a similar interest rate change, assuming your assets and liabilities are matched. So the main impact on the embedded derivative would be the change in the credit risk of the underlying assets. Some people call that a credit derivative slot.

I would also say that industry practice here is evolving. Undoubtedly, there'll be practice notes issued, and we'll hopefully see a convergence.

**MR. DARRYL G. WAGNER:** On our list of seven issues, we have five down and two to go. I'm going to talk about business combinations and Sarbanes-Oxley.

First I'll talk about business combinations. Relative to the other topics we're talking about, there's not as much brand new happening here, at least in terms of accounting guidance or late-breaking developments. I'm going to talk about a couple of things where we're seeing some general movement and things that have come about because of the current environment.

Most of this orients around purchase GAAP. Interestingly enough, out of the world of GAAP, I think purchase GAAP is probably one of the least well defined parts of GAAP accounting when you come to striking a purchase GAAP balance sheet and determination of value of business acquired (VOBA). There's not a lot of clear guidance as to how to do that. But we have seen a general movement toward an "actuarial appraisal method" for determining VOBA, which essentially is taking the actuarial appraisal framework that comes from SOP 19 using statutory earnings, distributable earnings and so on as the building blocks for your VOBA calculation. There is also movement toward typically including a charge for required capital, as you would in an appraisal.

There certainly are other methods that have been used over time, and there's no one right way to do this. You can get fairly different answers using some of these different methods, particularly if there's different treatment of this capital charge, which is going to have a big impact. The overall caveat is that any time you're dealing with this, it's important to have communication between the parties—buyer, seller, advisors, whoever's involved—to make sure there's an understanding of the basis that's being used and how that might compare to alternate approaches.

Craig touched on the CFO Forum that's put out this guidance on embedded value. You might ask, "What does that have to do with business combination or purchase accounting?" The reason I bring it up here is because some of the comments that are made in this embedded value paper could be carried over and applied to the science or art of actuarial appraisals. Therefore, since some of those techniques are used in VOBA determination, they could also impact purchase GAAP.

I have a couple other things that I would like to point out. First of all, an endorsement of using stochastic techniques for valuing financial options and



guarantees is not really a dramatic new thought, but it's not necessarily something that's been part of the actuarial appraisal methodology when you're valuing your company, say, in total. I just throw that out as something that will be interesting to watch in terms of both how appraisals are done and how purchase GAAP VOBA is done, as to how that's blended in. The growth of option-type products, such as VAs, as parts of blocks of business will probably make that happen naturally.

The other thing is around the area of risk discount rates. This paper talks about thinking about risk discount rates differently, more as a matrix of rates rather than a single rate, and there are two ways that might vary. One is with respect to the yield curve, if you want to think in terms of duration of the cash flows that you're dealing with. The other is also in terms of the product you're dealing with and perhaps even the region, if you're in a different country. There's been some differentiation in discount rates and appraisals over time, but not necessarily to this level. This is something to keep an eye on as this area of practice emerges.

One of the things we've been living through is a declining interest rate environment, which can have some particular effects when you're talking about VOBA. In general, lower interest rates are going to create capital gains within the asset portfolio, and marking the assets to market is generally part of the exercise for a purchase GAAP balance sheet. Thinking about how that affects the liability side of the balance sheet can often be an important consideration. For example, if I have a matched guaranteed investment contract (GIC), and I think it's profitable because of that matching, if I've marked those assets to market, it probably makes sense to have some kind of fair value adjustment on that liability. I would increase that liability to show that there are earnings in that business, even though a typical approach might be to not really adjust those kinds of liabilities.

Another example might be a participating type contract. If I have assets marked to market, I might want to think about whether I need a PDO type, referring to demutualization type accounting standards, to capture the liability obligation that those gains create.

Finally, we talked a lot about SOP 03-1, but as you start thinking about business combinations and purchase GAAP and due diligence, again, that is something to think about. Is this a company with products that trigger SOP liabilities? This really requires stochastic valuation, again, if I'm going to be thinking about re-striking some of these balances on a purchase GAAP balance sheet. Even further, as is often done, if I want to think about projecting balance sheet income on a GAAP basis, it may require me to do a stochastic in stochastic, if you will, because I have to re-strike at stochastic value at future points in time. That's going to tax computer capacity even more than just a stochastic calculation.

Next is Sarbanes-Oxley. I want to move through a few topics here, basically on the requirements and risk control, and talk about testing. In terms of the requirements, what are referred to as accelerated filers with the SEC are to comply with Sarbanes

as of December 31, 2004. By a show of hands, how many of you are in organizations that will have to comply with this at the end of 2004? It looks like a good number. This requires signoff by both management of the company and the external auditor on the internal controls and involves a lot of advanced planning.

The other thing to be aware of, though, is that the NAIC has gotten involved in this and is in the process of finalizing changes to their model audit law that would essentially put Sarbanes-Oxley equivalent type requirements into that model audit law. The upshot of that is that not just SEC filers but statutory filers, which basically means that anybody who's licensed would need to comply with Sarbanes-Oxley-type requirements with respect to your statutory financials.

This is obviously a big deal just because it broadens the impact of this. It also takes it down to a more granular level. You're now going to be talking about statutory entities, although the proposal currently is to be able to do this at a holding company level. If you're a company that has five or 10 Blue Book entities within it, you could consolidate those for Sarbanes-Oxley, and that's obviously an important point. This is, needless to say, a vigorously debated subject right now. The industry has strongly said it doesn't think the benefits of this justify the costs. I think the regulators have heard those arguments, but everything I hear says they still conclude that it is worth it and that it will probably come to pass either late this year or early next year. Assuming that happens, the Sarbanes-Oxley-type requirements become a reality for nearly all companies.

It's important to keep in mind that Sarbanes-Oxley is addressing financial-reporting-related risk, so this is not an enterprise risk management phenomenon. You're talking about risks that reflect what goes into the financial statements that you report, which involves a lot of things, but that is the scope. The typical actuarial involvement on this usually relates to reserving and DAC development—the kinds of things that actuaries are involved in doing with respect to financial reports. I tend to think of the high-level construct of the four big categories of risks that go along with those processes. One is the development of methods and assumptions; two is the integrity of the data that's used in those processes, the accuracy of the actual calculations; and then, finally, the disclosure, including making sure that the right numbers get to the right place in the financial reports.

Most of the focus is on controls. We have to test controls, but it's important to keep in mind that we have controls because we have risks. A risk assessment should come first, then an assessment of whether you have the right controls. There is a language barrier between actuaries and accountants on this topic. I think controls and internal controls have been a part of accounting jargon for a long time. It hasn't really been part of actuarial jargon for a long time, which is not to say that actuaries haven't been controlling their work, but many actuaries like to deny that they have controls or, worse yet, documentation of those controls when first asked about it. When you dig into it, you find that those controls are there. We just haven't necessarily referred to them the same way.

There is also kind of a bottom-up versus a top-down. The bottom-up refers to looking at the details of what I know I'm actually doing. I have processes. I have controls. What are those and how do I capture those? But it's also important that you go top-down to say what should I have here, and what risks do I have, and what controls, therefore, should I have? Hopefully you meet in the middle on that with a bigger list than purely from top-down and a smaller list than bottom-up that covers things.

One other point is that this isn't just an exercise in documenting what's happening now. It is supposed to identify gaps that may exist in the process and remedy them by either strengthening controls or creating new controls. The hard versus soft risks refers to professional judgment versus more data risks, and both of them do need to be controlled. The way you control them is different. We'll come back to that in just a minute.

I want to talk about testing, because by this time in the process a lot of companies have moved into the testing phase. You identify the risks. You identify the controls. You get some documentation going, and then you test. The way you really assess or demonstrate that you can make this signoff is to do the testing. It's important to remember you're testing the controls, not the process itself. So you have a process. You have a control in the process. Then you're going to test that control, not the original process.

The general types of tests are more what I call the accounting Sarbanes-speak for these kinds of tests—inquiry, inspection, re-performance and walk-through. Other than re-performance, these are really more qualitative—looking at the process, reviewing the output of it, reasonableness assessment. Re-performance actually means I'm redoing part of it and either getting the same result or reaching the same conclusion as was originally done. Obviously, the test should fit the nature of the control. These are new vocabulary terms for everybody, both accountants and actuaries, so we have to get some comfort as to what that translates into for an actuarial process.

In terms of documentation, it's fairly straightforward. It's who, what, why, how, when. There are a couple of things that usually come up here: Is this a key control or a secondary control? That's an important process to go through, because you typically will come up with a whole raft of controls, not all of which are key, and there's not an objective definition for what's a key control. But the idea is what are those controls that have the most significant impact both in terms of the ultimate financial statements and in terms of dealing with the most significant risks? That also drives your testing prioritization. You usually think in terms of preventative versus detective controls. Preventative is something that's done up front. Maybe I have something that prevents me from entering an invalid assumption into a system. Detective involves looking at the results after they've been produced and looking at trends.

In terms of characteristics, this is fairly straightforward. I would say that it makes sense to (and hopefully you can) leverage existing documentation, whether it is existing process documentation or job descriptions, but it does need to be centralized. Typically a Sarbanes effort is a company-wide effort with some kind of project management office (PMO), which is another buzzword that's gained popularity in the Sarbanes era. You'd be looking for consistency with the requirements that are being set up for the rest of the company.

Chart 1 is a very high-level example of the output of this process. When you get to the end of it, you basically want to say, "I've documented my processes, but, more importantly, I've documented the risks within those processes. I have the controls identified, and I have the tests of control identified." Here are a couple of very simple examples. One risk might be that the reserve assumptions I'm using don't reflect policy characteristics. That's one of those softer risks I'd refer to, because that obviously involves judgment and somebody who knows the product and knows the accounting guidance and puts them together in the right way. The control might be that there's a quarterly review and signoff, essentially a peer review, by another actuary within the organization. The test of that control might be looking at the minutes from that meeting and making sure that the things that were supposed to be covered were covered and maybe comparing that to make sure nothing happened during the quarter that wasn't talked about in that meeting.

A harder risk might be that the reserve calculations don't give reasonable results. This is something that's a little more familiar to us in terms of controlling, and the way you control that might be to independently recalculate some of the reserves and check those. The test of that control might be a re-performance of some of the control, but now you're testing a subset of the subset that you originally tested. So it can get confusing. The other thing to remember is you have management signing off, but you also have the external auditor. So it may be that internally you have a control, but the external auditor is going to have its own version of that, and there are some rules of thumb we can talk about with that.

**MR. REYNOLDS:** I think I put Darryl, David and myself in an unfortunate spot on that issue of how to define the death benefit on the UL plans. Do either of you want to comment and clarify your views on that, in case I misrepresented you?

**MR. SCHEINERMAN:** Before the session, Craig asked us if you had a vanilla UL insurance contract, and you're analyzing the death benefits relative to the COI charges, what is it that you end up accruing the liability toward? What is the death benefit? In that situation, I was interpreting it as a UL contract without a no-lapse benefit feature, and so it is the basic death benefit in excess of the account balance that's subject to the SOP calculations. However, when you have a no-lapse guarantee, the SOP in the early section talks about insurance benefit features, and it references the no-lapse benefit feature as another insurance benefit. So I think it's commonly interpreted as a separate benefit from the base insurance benefit. If

you have profits followed by losses through the no-lapse guarantee, then you would only account for that as part of the initial liability rather than all the death benefits.

**MR. WAGNER:** I would agree with that. In general, one of the things that this new practice aide says is you should look at different benefit functions separately. If you have a UL contract with a no-lapse guarantee, I think you have at least two pieces to look at—the base mortality piece and the no-lapse guarantee. In both cases, you're essentially trying to take total assessments and total benefits associated with both of those streams, which in the base mortality would include everything. But on the secondary guarantee it would just be incremental base effects.

**MR. SCHEINERMAN:** In base mortality, it could yield a significant change in the profit profile of the contract, whereas with the no-lapse guarantee it typically doesn't.

**MR. MICHAEL E. DUBOIS:** For SOP 03-01 with regards to the stochastic testing, the quote in the slide that you had also goes along with a couple of other spots where it indicates considering a full range of scenarios. What seems to be the broad practice now is interpreting that; you do a range of scenarios and take the mean of those results. In taking a look at this, most of these products, when we're talking about the VA GMDBs or the living benefits, have been priced at a point other than the mean. What concerns me about the interpretation that we're making is to take things to an extreme. Say we have a product that has only one revenue at issue. In that case, what we're doing in setting up a reserve is essentially releasing a large portion of whatever charge we have set up as profit before we have any idea what's going to happen in the future. Is this an appropriate way to be handling this, being that it has a basic inconsistency with the pricing and economic situation that we're looking at with benefits that have a large amount of volatility in the future?

**MR. REYNOLDS:** I think your observation is valid in terms of what the impact of this is. I think it's true that the SOP, as written and in common practice as I've seen it so far, is based on the mean. Clearly, that would be inconsistent and inappropriate for a statutory or regulatory reporting basis. It's less clearly inappropriate for GAAP. I do take some comfort in the fact that there is some dynamic unlocking going on so that, over time, if experience emerges in such a way that your guarantees are moving in the money, you'll be gradually accruing that benefit rather than taking the hit all at once. But you're right; there is a loss of any pricing conservatism that's going to come in as profit at issue which is, arguably, inappropriate.

**MR. WAGNER:** It is an interesting observation. I think the authors would describe the SOP liability as a hybrid of bringing some FAS 60 type thinking into the FAS 97 world. Using the mean approach, you could argue you're using "best estimate" assumptions, which is consistent with the way other things are done in FAS 97. The EGPs are done in FAS 97. So there is some consistency there. You could say, "Well, if I want to focus more on the FAS 60 part of the hybrid, should I put some

provision for adverse deviation in like I would on a FAS 60 contract?" It's a good observation, but I do think that we're looking to keep as much consistency with the FAS 97 framework as well. Part of that is because you do have the unlocking, as Craig mentioned, which you don't have on a FAS 60 basis. You have that way to make sure you don't get too far out of the money.

**MR. EDWARD C. JARRETT:** I want to follow up on the same issue and pose a particular situation. Most companies that I've seen, in terms of their projected equity returns on their variable funds, have been somewhat conservative in their projections for their DAC amortization, much less so than the expected return on the equity. How do you balance that conservatism, which may have been put in 10 years ago, with the reserve calculation where you need to use expected values or the expected mean return of the equity? There seems to be a process where in past years we've actually built in some conservatism in our DAC amortization, and now we're in a battle where you take a whole stochastic series of scenarios on equity returns, and the mean is 11.5 percent, but no one really wants to use that for their DAC amortization. How do you balance those two things?

**MR. REYNOLDS:** I'm not sure I have any great insight on this, but I'll offer one comment and then yield to my fellow panelists. You're right. There is an inconsistency there, and I think essentially what you're saying is that we're going to be conservative on the DAC and less conservative on the reserves. That still makes overall on a net GAAP liability basis, which is really what matters because we've been conservative on the DAC, but maybe our net is still conservative.

**MR. JARRETT:** So you're willing to have clients use a higher average return for the reserve calculation but a lower average return for the DAC amortization. Are you guys all signing off on that?

**MR. REYNOLDS:** Well, I'm not an auditor, so I don't have to sign off on it, but I believe it is one implication of what you would likely see. I'll let my accounting firm colleagues comment.

**MR. WAGNER:** We're not signing off on anything today. In theory, the DAC assumption for returns ought to be a best estimate, and I think, as you rightly point out, in practice, given the extreme volatility there, if we've erred, we've probably tended to err on the conservative side. Certainly what we've been looking for and trying to achieve is consistency. In theory, there ought to be consistency between that DAC return assumption and the mean of the stochastics that are used. In practice, you may or may not see that very close depending on the amount of this conservatism that is there. That would be the goal, and I think it's an area where practice is going to be evolving. Quite frankly, there's been a lot of effort just to sort out what the SOP means. Now that more of that seems to be in order, I think there will be more attention paid to some of these kinds of issues as well.

**MR. SCHEINERMAN:** I'd agree with that.

**MR. JARRETT:** Another question I had was a clarification to some comments the panel made earlier about what cash flows are reserved for the no-lapse guarantee under UL contracts. I wasn't sure if you were settling on the death benefits paid when the no-lapse guarantee feature was "in force," meaning keeping the contract in force. I wasn't sure where you actually came out on that.

**MR. SCHEINERMAN:** I would expect that there is some diversity in practice relative to this, because people have come up with different definitions. In general, people are focusing on the death benefit paid when the contract would have lapsed. It's only in force because of the no-lapse guarantee. Death benefits paid during that period are the benefit, and total assessments of the contract are the revenue item. I think charges that have been waived have been discussed, but I don't generally think that that's being used.

**MR. JARRETT:** I heard three or four months ago that the accounting firms were leaning toward the definition that you just mentioned as being the preferable reserving cash flows or the benefit cash flows to reserve for.

**MR. WAGNER:** To the extent that I've seen it, I agree with your observation, David. That's the most common way, but there are definitely companies out there that are taking other interpretations. It's still evolving.

**MR. REYNOLDS:** I have a quick question for either one of my fellow panelists. It pertains in particular to business combinations. Darryl talked about setting the VOBA and the various methods out for that. Traditionally in purchases, the issue of how to set the liabilities on interest-sensitive business has been an interesting one. Most companies that I've seen just say, "Well, it's account values, just like it is on historical GAAP (HGAAP)," but I'm starting to see at least some companies marking the liabilities to market on interest-sensitive business as well. I'm wondering to what extent you've seen that and can comment on practice.

**MR. SCHEINERMAN:** In my experience, I've still seen folks focus on account balance for the liabilities, but they don't view that as fair value of the liabilities because you do then determine VOBA and consider the net liability to be a fair value. I've also even heard people talk about policy loans rather than holding them at the policy loan account value, adjusting them to fair value, and I know of at least one company that's done that. So, like Darryl said, it's open to a lot of interpretation.

**MR. WAGNER:** I would generally agree with that. The two examples I threw out were both not account-value based. You're probably going to see more of it there, but in theory it ought to come out in the wash with the VOBA, because whatever adjustments you make to the reserves should work their way into the VOBA. I think if you have a loss recognition situation, that's one where you may see an adjustment going to gross premium reserves or something like that.

**MR. MARK E. ALBERTS:** I will ask a FIN 46 question. Do you have any comments on the applicability of FIN 46 to captive reinsurers, like agent-owned captives?

**MR. SCHEINERMAN:** I have not gone into an analysis of that, but I think it would have to go through that model as to who owns the majority of the risks and rewards. If the agents own the majority of the risks and rewards rather than the parent, then perhaps it would not get consolidated.

**MR. ALBERTS:** I have a second quick FAS 133 question. One comment that you made was something I hadn't necessarily thought of before, that if the liability is held at fair value, there's no bifurcation. That doesn't mean for insurance liabilities like EIA liabilities that you can get away from bifurcation by holding the whole thing at fair value, right?

**MR. SCHEINERMAN:** I'm sorry. Was that related to purchase accounting or in general?

**MR. ALBERTS:** No, just related to FAS 133.

**MR. SCHEINERMAN:** No. The comment was about if the contract is already held at fair value. Let's say you have an investment bond that has an index within it. If it's already being held at fair value, then you wouldn't separately bifurcate, but within an EIA the accounting model is not one to hold the base contract at fair value. So, you would bifurcate in fair value only the indexed annuity. That's correct, the indexed part of it.



Chart 1

## Illustrative Risk/Control Matrix

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Risk	Control	Test of Control
Reserve assumptions do not reflect policy characteristics	Quarterly review and sign-off of assumptions by chief actuary	Inspection of minutes from quarterly review meeting
Reserve calculations do not product accurate and/or reasonable results	Quarterly systematic independent recalculation of selected reserve amounts	Reperformance of recalculations for a subset of the population tested