The Actuary

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Interest Rate Spread Cont'd.

STATUTORY	
Summary of Operations	
Prem	XX
NII	100
Bfts & Expns.	
DB etc.	XX
Gain from Ops.	100
CAPITAL & SURPLUS (C&S) ACCOUNT	
Beginning C&S	XX
GFO	100
Net RCG & UCG	40
Change in MSVR	(30)
Ending C&S	110

Balance Sheet

Assets	Liabs	
XX	MSVR	+30
	C&S	+110

As the chart indicates, there are some decisions yet to be made before any conclusion as to spreads can be drawn — the first of which is whether Statutory, GAAP, or both bases are to be the standard of measurement.

If all we are doing is measuring past spread results, deriving answers for both merely involves the extra work of doing the calculation on two bases. If, however, the intent is to develop a new rate recommendation, any differences between the bases creates a more complex problem since there is no way to declare separate Statutory and GAAP rates to the contractholder. Choices will have to be made, or the asset allocation decisions will have to be adjusted to balance potential differences.

If GAAP basis results are chosen to govern, a key remaining decision is to determine the treatment of the $10 of unrealized loss. Electing to ignore it could be justified, either on the basis of a focus on the earnings statement or by arguing that the loss may likely reverse itself. (Note: these two are not independent, since the "reversal argument" is the logic behind the GAAP treatment of excluding it from current earnings.)

Alternatively, a company may wish to conservatively state its past earnings position to management by immediately recognizing any unrealized losses. In setting new rate actions, it may also choose to scale back its total return expectations. Much may depend on the length of the guarantee being declared and the inherent volatility of the underlying assets.

On the Statutory side, the key issue is the treatment of the MSVR as it relates both to the required annual contribution and the absorption of all realized and unrealized capital gains. As the chart shows, the required statutory contribution to MSVR effectively removes $30 (plus whatever the required annual addition is) from the current period's contribution to ending capital and surplus. Therefore, depending on whether true statutory surplus (TSS) or strategic surplus (TSS + MSVR) is the target result being managed to, the earnings assumed would be either $110 or $140. Earnings of $150 would be considered only if unrealized losses were backed out.

Additional Observations/So What

That different answers are possible raises some interesting points regarding asset allocation and competitive standing — even among companies with identical proclaimed interest margins of *X* basis points.

Those companies managing to Statutory Ending Capital and Surplus results (i.e., $110 in our example) reap little competitive benefit from assets subject to MSVR whose total return is weighted toward capital gains. Therefore those companies are likely, if competitive credited rate considerations drive the asset allocation decision, to avoid heavy positions in those types of assets regardless of their positive impact on strategic surplus.

Alternatively, those companies are in a much better competitive position (albeit the possible hit to strategic surplus) regarding assets subject to large realized losses absorbed by the MSVR. To see this, just compare the Statutory C&S and GAAP results substituting a realized loss totally subject to MSVR of $40 for the gain of $50 in the example. In light of recent market events, this is more than an academic point. (Note: Even with identical performance and spread targets, differences in credited rates could still arise among companies managing to the Statutory C&S financial target based on each one's current level of MSVR — as it impacts the required annual contribution and degree of absorbable gains and losses.)

Lastly, lest a mistaken impression be created, absent any and all differences arising from varying financial targets, investment portfolios or target spreads, a range of credited rates is still likely to be found in the market. This is so because different companies — managing to GAAP results for example — may choose to pass along varying amounts of current period realized gains, based on each one's own assessments as to likely future performance, desired variability in declared rates, and current market demand. Stated differently, even in stable interest environments, the target spread may reflect more of an average to be achieved over the product's perceived time horizon than a rigid period-to-period requirement.

Conclusion

When presented with a given period's actual (or assumed) investment performance — which includes realized and unrealized capital gains as well as plain vanilla interest income — it is not immediately obvious which figures should be used in calculating the spread earned (or alternatively, in setting new liability credited rates to achieve a given spread). The choice may well hinge on the basis chosen for measuring the financial results the company is trying to achieve — and within a given basis on its attitude toward recognition of realized and unrealized gains/losses and the status of the MSVR.

Not all companies or actuaries are likely to agree on a given approach — a fact which carries financial statement, asset allocation, and competitive implications. Even where agreement exists as to financial targets, individual company preferences as to the timing for recognizing results in rate actions or management financials all but guarantee a wide range of outcomes attributable to identical combinations of investment performance results and spreads.

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Practitioner's Award Announced

The Actuarial Education and Research Fund is pleased to announce the introduction of a new award that will be presented for the first time in 1988. The purpose of this award — The Practitioner's Award — is to:

- recognize the research which is done in the non-academic actuarial community, and,
- encourage the publication of research conducted during the actuary's daily work.

The rules of the award can be found in our insert to this mailing.

If you have any questions or comments about the award, please do not hesitate to contact Randall J. Dutka at (416) 863-3634 or Douglas C. Borton, Chairman of A.E.R.F., at (201) 449-6713.

We will look forward to a successful competition.