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Appraisal cont'd

changing how they structure and document their analyses. For example, year-by-year projection information now often supplements present value calculations. Also, more and more sensitivity testing is found in M&A-related actuarial reports.

Quality control issues

Quality control ultimately is the responsibility of individual actuaries and their companies. To the extent that the actuarial profession establishes clear principles and general standards for practitioners, the quality control process is enhanced.

However, each actuarial practitioner and actuarial firm has a unique way of doing things that cannot be ignored in evaluating the quality control process. For example, some firms have detailed rules on process that are imposed on all appraisal reports, while other firms operate with more general guidelines. Neither approach is inappropriate. What is important is that the professional and structural issues be addressed first to assure that the right job is done before checking that the calculations are right.

The public expects the actuary involved in the M&A arena to provide expert, objective analysis. On the other hand, the M&A arena places many pressures on actuaries and professionals to shape their work in "special ways" because of the commercial aspects of transactions. Two critical questions are:

1. What should be the actuary's role (and responsibilities) in M&A work?
2. What principles and standards for analysis and reporting follow this definition of the actuary's role?

These questions mirror closely related issues facing the actuarial profession. How do/should we weigh scientific and business aspects when we define the foundation for our profession and the resulting standards for our work? In the M&A environment, is our role to be (a) an independent, objective quantifier or (b) an insurance company appraiser?

The continuing effort by actuaries in the M&A field to resolve these issues will help draw from and contribute to the profession's effort to set our future path.

Robert B. Shapiro is President, The Shapiro Network, Inc.

Grandfather ungrandfathered

by David S. Lee

The (U.S.) Technical and Miscellaneous Revenue Act of 1988 has created a very significant administrative problem for companies having a large block of "grandfathered" universal life business. The problem is that seemingly harmless future changes in benefits are categorized as "material changes," causing a policy to lose its grandfather status and subjecting it to the "modified endowment" rules. Consider the following example:

On January 1, 1986, John Doe purchased a $100,000 universal life policy from XYZ Company. John is 45, married, with one daughter. His planned annual premium of $2,000 is well below the guideline level premium limitations. The policy is grandfathered under the 1988 Act, because it was issued prior to June 21, 1988.

On January 1, 1991, John adds a family term rider to his policy. Since it is now after June 21, 1988, and the rider is considered a qualified additional benefit, the addition of the rider constitutes a "material change," and the policy loses its grandfather status and falls under the modified endowment rules. The 7-pay limit, adjusted to include the cash value of $10,106, is calculated to be $4,716 per year. This adjusted 7-pay limit is well in excess of John's planned premium, so the policy is not close to being a modified endowment. Therefore, the company implements the rider addition without discussing the "grandfathering" and "ungrandfathering" status with John.

On January 1, 1993, John reduces his $100,000 universal life policy to $50,000. The tax law then requires a recalculation of the 7-pay limits. The formula requires going back to the date of the "material change," January 1, 1991, assuming the death benefit from that time forward is the current death benefit of $50,000 and recalculating the 7-pay premium limitation as of that date. The new 7-pay premium limitation is $1,535 per year, which is below the premium John has been paying. Therefore, the reduction in death benefit has caused the policy to become a modified endowment.

In 1993, John's daughter begins college. On January 1, 1994, John makes a partial withdrawal of $2,000 to help defray tuition costs.

John is taxed "interest first" on his partial withdrawal and also must pay a 10% penalty tax. Had John not added the family term rider in 1991, the same $2,000 withdrawal would not have resulted in a taxable event because it would have been taxed "basis first."

John is infuriated when he learns that he is taxed "interest first" and has to pay a penalty tax. He has only $1,300 remaining after tax to pay the bills. "Nobody ever explained any of this tax stuff to me," John exclaims. John is even more infuriated when he learns that had he not added the family term rider, he could have made the same $2,000 withdrawal, and it would not have resulted in a taxable event because it would have been taxed "basis first." "Why didn't someone tell me of these potential tax consequences when I first added the rider?" he asks.

The end result of this example:

(1) John surrenders his policy.

(2) John tells all his friends and acquaintances that XYZ is a terrible company and that anyone who buys insurance from them is crazy.

(3) John sues XYZ Company and collects a tidy sum.

(4) The policyowner service rep handling this case has a nervous breakdown from the accumulated stress of this case and the 999 similar cases he handles.

The problem illustrated by this example is that companies need to notify policyholders of the potential tax consequences when they make "material changes" to grandfathered policies, even if those changes don't result in the policies' immediately becoming modified endowments. Since attorneys, actuaries, and other insurance professionals are having difficulty understanding and interpreting this complex law, the type of communication required to allow grandfathered policyholders to understand their situations will be difficult or impossible to design. The price of administering inforce universal life

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Grandfather cont'd

business just went up, and it may be more than companies can afford.

David S. Lee is Vice President and Actuary, United of Omaha Life Insurance Company. An Assistant Editor of *The Actuary,* he is a past member of the ACLI's Task Force on Section 7702, Definition of Life Insurance.

Managing investment risk and returns

The Investment Section will sponsor a seminar on "Managing Investment Risk and Returns" April 17-18 at the Marriott Marquis in New York City.

The seminar will focus on practical techniques for managing investment risk and enhancing returns for a broad array of both interest-sensitive and portfolio products. The agenda is:

Monday afternoon (April 17) – three modules: "Mortgage-Backed Securities and Other Asset-Backed Securities;" "Futures and Options;" "Equities and Equity-Linked Vehicles"

Tuesday morning (April 18) – two focus sessions: "Controlling Interest Rate Risk" and "Return Enhancement"

Tuesday afternoon – case studies on "SPDA and Universal Life;" "Participating Insurance;" "Immediate Annuities and Structured Settlements"

The seminar faculty is a distinguished group of investment actuaries, consultants, investment bankers, and investment executives with hands-on experience in managing risk to enhance returns. Luncheon speaker Irwin Vanderhoof will talk on "Pilgrim's Progress: A Perspective on Managing Risk and Returns."

Time will be provided for questions and answers at the end of each session and at a final Open Forum where faculty members will take questions from the audience.

Early registration material was mailed out in mid-January. Registration fees are as low as $200 (U.S. funds) for Investment Section members who register early. Questions may be directed to Ken Stewart at 212-747-7006, or to Pete Bondy, Greg Carney, or Howard Kayton at their *Yearbook* addresses.

FACTUARIES

In the spirit of "turnabout is fair play," this month's "Factuaries" profiles the feature's perpetrator.

Name: Deborah Poppel

Birthday: January 17, 1955

Birthplace: Brooklyn, New York

Current hometown: Concord, Massachusetts

Current employer: John Hancock

Children: Maxwell, 5

My first job was: as a counselor at Deerkill Day Camp.

I'd give anything to have: a flat stomach.

The number of exams I flunked: 1 or 3 depending on when you start counting.

The books I recommend most often: *The Princess Bride, The Phantom Tollbooth.*

The last movie I saw: *Punchline.*

Nobody would believe it if they saw me: cleaning.

If I could change one thing about myself, I'd: be nicer.

When I'm feeling sorry for myself: I read trashy books.

My fantasy is: to have the elevator at Hancock open and 50 people be singing, "Well, it's been a long day," as in "How to Succeed in Business Without Really Trying." (That's my clean fantasy.)

The silliest thing I've ever done: is to put a picture of a dog over my picture on my company ID. It worked for a week. (It was a particularly attractive dog.)

If I could do it over I'd have: taken more advantage of my college years.

My proudest actuarial moment was: creating and publishing "The Actuarian" in the November 1985 *Actuary.*

The best time of my life is: spent performing.