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"A KNOWLEDGE COMMUNITY FOR THE SOCIETY OF ACTUARIES"

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The Financial Reporter

The Newsletter of the Life Insurance Company Financial Reporting Section

SOP 05-1: Eleven (or Twelve) New Things to Consider

by Robert G. Frasca

Disclaimer: The author is not a CPA and is not purporting to give accounting advice, but is describing what the Life Financial Reporting Committee understands to be a developing area of interest for actuaries. Companies should seek advice from their accountants in the application of all FASB standards and other accounting pronouncements.

Although adopted over a year and a half ago, the AICPA's Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts* (SOP), continues to generate a considerable amount of attention. Companies that started to prepare for implementation in anticipation of a Jan. 1, 2007 effective date encountered numerous questions of interpretation that appeared to increase as they considered all the transactions that could be considered contract "modifications" under the SOP's wide reach. In recognition of both the perceived ambiguity and administrative complexities, several companies petitioned the Financial Accounting Standards Board (FASB) either to delay the SOP's effective date, or to kill it altogether. This led to a "roundtable" in early January at which the FASB heard the perspectives of various interested parties. Though the FASB ultimately rejected any appeal for delay, it indicated no objection to the release by the AICPA of a series of 11 Technical Practice Aids (TPAs)[1] addressing many of the issues that had created uncertainty and a resulting potential for diversity in practice. Though companies have by no means gotten over the pains of implementation, clarity has at least been provided on many of the most perplexing questions with which companies had been struggling.

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[1] A 12th TPA had been proposed but, as of mid-March, when this article was written, had not formally been released by the AICPA, pending continuing discussions with the FASB.

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Take, for example, the treatment of group business. Companies that classify their group health and group disability contracts as long duration contracts under FASB Statement No. 60 struggled with the application of the SOP to their business. Paragraph A27 of the SOP suggests that reunderwriting a contract constitutes a change in the degree of the insurance risk as contemplated in Paragraph 15a, resulting in a substantially changed contract and the need to reflect the transaction as a termination of the original contract in the amortization of the deferred acquisition cost asset (DAC). Does the negotiation of benefits and rates on renewal of a group contract constitute "reunderwriting" in the context of the SOP?

TPA 6300.32 appears to provide an answer. It repeats the notion, presented in the SOP, that making premium rate adjustments in the ordinary application of guaranteed renewable business does not constitute an internal replacement, as defined in Paragraph 8 of the SOP, provided that the ability to make such adjustments exists in the original contract. The TPA goes on, however, to note that a defining element of the term "guaranteed renewable" is the idea that premium rates would be adjusted by class of policyholder. This would suggest that premium rate adjustments that reflect policy-by-policy experience are not consistent with the guaranteed renewable concept and, consequently, involve an element of underwriting that would render the modification an internal replacement.

The TPA develops these points to provide for the treatment of premium rate adjustments under group contracts. It identifies the adjustment-by-class concept as key to determining whether rate adjustments on such contracts are internal replacements. By themselves, rate changes on group contracts will not constitute internal replacements if the changes are made on a class-of-business basis and if the changes are not tailored to recognize the individual circumstances of specific contracts.

TPA 6300.32 introduces another concept in its discussion of group business: the idea that the exercise of judgment on the part of the insurer is an indicator that an internal replacement has occurred. For example, rate action that is formulaically defined in a contract, even if applied at the individual contract level, would not constitute an internal replacement because it occurs without the exercise of discretion on the part of the insurer; it is simply a defined mechanism of the contract. By contrast, the exercise of judgment or renegotiation in the establishment of rates is considered to be *de facto* underwriting and consequently would likely constitute a substantial change in the contract. This judgment criterion is central to another issue addressed in the TPAs. Upon adoption of the SOP, companies had questioned whether simple adjustments, like the movement of a policyholder from "smoker" to "non-smoker" status or the reclassification of a juvenile insured upon reaching the age of maturity, would constitute reunderwriting, presumably resulting in the release of DAC, under the SOP. TPA 6300.28 addresses this point by stating that activities performed merely to confirm information are not to be considered "underwriting" in the context contemplated by the SOP. Again, the interpretation hinges on the concept of the exercise of judgment on the part of the insurer. If there is no discretion on the part of the insurer, then simple actions, like the examples above, would not trigger an internal replacement *per se*.

... the TPA acknowledges that multiple approaches exist to determine whether a change in the degree and kind of insurance risk has occurred. Companies must determine which approach or approaches best analyze the substance of the change.

Another issue addressed in the TPAs is the definition of what constitutes a "significant" change in the insurance risk under a contract. Paragraph 15a of the SOP states that a contract cannot be deemed substantially unchanged unless it is determined that the mortality, morbidity or other insurance risk has not changed significantly. The SOP provides some examples of how this significance might be determined, but leaves the question of where the dividing line between "significant" and "insignificant" lies largely unanswered.

TPA 6300.26 attempts to fill this gap. However, those looking for a bright line test for significance from the TPA will be largely disappointed. The TPA reiterates concepts outlined in the SOP: that any conclusion must be based on facts and circumstances and that it is important to look through to the substance of the contract in determining what type of test to apply. For example, it would appear inappropriate to base the analysis of a change from a life insurance contract with a level death benefit to one with an increasing death benefit solely on the basis of total cost because, whereas the expected net cost over the life of the two policies may be the same, the pattern of death benefit protection could be vastly dif-

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ferent. Therefore, the TPA acknowledges that multiple approaches exist to determine whether a change in the degree and kind of insurance risk has occurred. Companies must determine which approach or approaches best analyze the substance of the change.

What the TPA does not make explicit, however, is whether the conclusions of multiple tests must *all* be considered in making the determination. For example, the TPA describes several ways to assess "kind and degree" of mortality risk between a 10-pay and a 20-pay life insurance contract. It observes that different conclusions may be made concerning whether the change is deemed significant or not depending on which test(s) is (are) selected. Though not stated explicitly, it seems to suggest that it is not necessary to look at all possible ways to consider significance, but that at least one test appropriate for the type of policy and risk is required. Presumably, whatever tests are selected should consider the nature of the risk in some reasonable manner that encompasses the main attributes of the risk. In addition, the TPA makes it clear that whatever means of assessing significance are chosen, those same tests must be applied to similar products with similar risks. Consistency of treatment is a primary concern.

Though again not explicitly stated, the TPA also suggests that quantitative demonstrations of some sort are desirable in proving the point related to significance of the degree of insurance risk. So, while some obvious qualitative questions should be considered first in assessing the kind and degree of insurance risk under Paragraph 15a (e.g., "is the insured event unchanged?" "is the period of coverage materially the same?") quantitative demonstration will likely be necessary before arriving at a conclusion of "substantially unchanged" when either premiums or benefits are modified under an internal replacement.

To some, TPA 6300.26 may appear unsatisfying as it fails to deliver bright line thresholds regarding significance or definitive tests to use when assessing degree of insurance risk. Others, however, would observe that greater definition would be impossible given the range of products that exist currently or could be developed in the future. Inevitably, some diversity in practice is likely to develop, though by providing a more refined language for discussing degree and kind of insurance risk, the TPA should make the range of practice smaller than it might otherwise be.

Before leaving considerations associated with the "kind and degree" language of Paragraph 15a, it is worth noting one area in which the TPAs provide additional definitive guidance. TPA 6300.33 makes it clear that, when assessing whether a modification results in a substantially changed contract, any change in the period of insurance coverage should be assessed from the date of modification, not from the original date of issue. This should answer specific questions related to modifications that happen late in a contract's lifetime (for example, election of an extended maturity option at the age 95 maturity of a life insurance policy would appear to result in a substantially changed contract under the TPA).

Similar to the questions that arose regarding the interpretation of "kind and degree" of insurance risk, companies attempting to implement the SOP ran into difficulties with how to assess the "nature of investment return rights" as described in Paragraph 15b. Modifications that change the nature of investment return rights result in a conclusion that a contract has been substantially changed with the consequential treatment of the original contract as being extinguished. Recognizing, in particular, that Paragraph 15b does not refer to the amount of investment return the way that Paragraph 15a refers to the "degree" of insurance risk, some had questioned whether this set a different threshold for changes related to investment return rights than for changes related to insurance risk. While not answering this question directly, the TPAs give guidance that will help companies to draw conclusions when applied to specific situations.

TPA 6300.27 considers a common situation encountered by many companies, the raising or lowering of investment management fees on subaccounts under variable life and annuity products. Typically, the right to change such fees, as well as the right to change other asset-based fees, is spelled out in the contract. The TPA states, in effect, that changing such fees does not result in a substantially changed contract provided that it does not fundamentally change the investment return rights under the contract. In a typical situation, where fees are being changed by a few basis points on a contract expected to yield a net return to the policyholder of 4 percent or more, it would not appear that a substantial change has taken place. Again, no bright line is given within the TPA, but the fact that changing fees does not, per se, result in a substantially changed contract provides a level of flexibility that the SOP itself had not made entirely clear.

Consideration of other changes in the nature of investment returns is included in the TPAs as well. TPA 6300.34 emphasizes points made within the body and appendices of SOP 05-1 to indicate that the "nature of investment return rights" should be considered broadly to encompass not only the form of how returns are credited, but also the level and timing of any return guarantees under the contract. In what appears to be language aimed directly at the proliferation of minimum performance guarantees under variable annuity products, the TPA expands on language in Paragraph A30 of the SOP. Specifically, the TPA states that changes in the cash flow timing or strike price associated with a minimum performance guarantee must be considered in assessing whether the nature of investment return rights have changed. The implication is that substitution of one guaranteed benefit for another with an identical expected cost must still be considered under Paragraph 15b because other elements of the guarantee may result in a substantially changed contract. So, for example, the exchange of a variable annuity with a guaranteed minimum withdrawal benefit for an otherwise identical contract with a guaranteed minimum accumulation benefit would appear to almost always result in a substantially changed contract.

As with the assessment of the degree of insurance risk, no definitive tests or thresholds are provided for assessing the nature of investment return rights. However, the TPA does suggest that considerations similar to those used for changes in guaranteed minimum interest crediting rates should be applied when strike prices are changed on guaranteed minimum accumulation benefits. To some, this might indicate that as long as the two guarantees are not significant in the current environment, a substantially unchanged internal replacement has occurred.

The TPA appears to be suggesting that if there is any question of classification, then the modification should be treated as integrated with the base contract.

To others, however, it would appear inadequate simply to assume that the substitution of one out-of-the-money guarantee for another of equal cost would result in a substantially unchanged contract. Just as a higher interest rate guarantee may change the nature of investment return rights on a fixed annuity, not because it will change the level of returns in the majority of scenarios, but rather because it will significantly change the return in some significant subset of scenarios, so it would appear that an analysis of the returns realized under various scenarios should be compared to assess whether the exchange of one guarantee for another results in a substantially changed variable annuity contract. This view places a more substantial, quantitative burden on a company to assess the significance of a change. Whether this level of rigor is required or not is left unstated by the TPA, though its wording makes it clear that a justification that ignores the substance of the differences in the guarantees will not suffice.

Other issues are addressed by the TPAs as well. TPA 6300.25 states that unless modifications are deemed to be nonintegrated, they must be assessed to determine whether they result in substantially changed contracts or not. It also provides some limited guidance to help determine whether a contract feature is considered integrated or not. The TPA appears to be suggesting that if there is any question of classification, then the modification should be treated as integrated with the base contract. However, it adds little to the concept as originally described in the SOP.

TPA 6300.29 states that a contract reinstatement should be considered as the extinguishment of the initial contract and the issuance of a new contract if there is any period of time prior to the reinstatement during which the original coverage has genuinely lapsed (i.e., the company would not have paid a benefit if an insured event occurred during that time). This TPA addresses an issue that some would consid-

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er to have existed even absent the adoption of the SOP because the issue involves when a contractual obligation ceases to exist rather than the modification of an in-force contract. Some companies will view this as an insignificant item, presumably because they either have little reinstatement activity or currently follow the practice outlined in the TPA anyway. Others may find this TPA to constitute a major change to how they account for a fairly common transaction.

TPA 6300.30 answers the question of whether commissions paid on additional coverage elected under a universal life insurance contract may be considered as deferrable acquisition expenses even though the additional coverage does not result in a substantially changed contract. By stating that such expenses may be deferred and amortized, the TPA recognizes the substance of such a modification as the sale of additional insurance coverage, thus enabling the deferral treatment. This conclusion almost appears to recognize a hybrid type of modification, one that is not considered nonintegrated in the technical sense of the SOP but for which recognition of the expenses associated with the modification as if they were separable from the integrated contract best reflects the substance of the modification.

TPA 6300.31 resolves an apparent inconsistency between SOP 95-1 and SOP 05-1 as they relate to the treatment of dividends used to purchase paid-up additions. The TPA states that the direction in SOP 95-1 that treats the activity under paid-up additions as part of the estimated gross margins of the original participating life insurance continues to be valid, even if the paid-up additions are determined to be non-integrated modifications of the original contract under SOP 05-1.

Finally, SOP 05-1 recognizes that adoption of the SOP might lead some companies to recognize transactions that had previously not been treated as extinguishments as additional lapses in their estimated gross profits used for amortizing DAC on FAS 97 contracts. According to Paragraph 31 of the SOP, any resulting change in DAC from this change in treatment on adoption of the SOP should be reflected as an adjustment to retained surplus and not through earnings. TPA 6300.35 provides that FAS 60 contracts should get similar treatment upon adoption of the SOP. Specifically, it says that DAC and reserves associated with such contracts should be adjusted through retained earnings to the extent that a shorter life for the contract would have been assumed had the SOP been in effect on the date when the contract was issued. The revised life is based on the period from inception to the next expected substantial modification after adoption of SOP 05-1.

Presumably, this TPA should not be interpreted to suggest any sort of softening of the lock-in principle afforded to FAS 60 contract reserves. It would not appear appropriate, in other words, to reflect any experience or change in assumptions that might have arisen after issuance of the contract in establishing the valuation assumptions on adoption of the SOP. Rather, the TPA appears to require the valuation at adoption to reflect all of the same assumptions that were originally established at issue. This would apply to assumptions for internal replacements as well, though the life of the contract would equal the period of time that has already elapsed between issue and adoption of the SOP and the expected time between the adoption date and the date on which the next substantial modification to the contract (including lapse) is expected to occur.

The 11 TPAs discussed above were issued by the AICPA on February 22, 2007. At that time, a 12th TPA had been drafted but was not issued, pending a request by the FASB for further clarification. At the time that this article was written (in mid-March) it was unclear whether the 12th TPA would ultimately be issued.

This "draft TPA" addressed a situation that appeared possible under a literal application of SOP 05-1 but that would cause what many would consider to be

unreasonable financial reporting. Namely, the situation is one where the SOP deems an internal replacement to result in a substantially changed contract, requiring the release of reserves from the original contract even though the risk for which the reserves had been established remains.

One type of contract where this could occur is a variable annuity with a guaranteed minimum death benefit. For example, a contract guaranteed minimum death benefit that is in-the-money could be exchanged for a substantially changed contract with the death benefit transferring over. If a reserve for the death benefit had been accumulated under SOP 03-1, the reserve would have to be released in applying SOP 05-1. Absent any other adjustment, the exchange could result in the generation of income from the release of the reserve, even though the death benefit was unaffected by the transaction.

The draft TPA addresses this concern by stating that the consideration paid for the new contract should include not only the cash received upon extinguishment of the old contract, but also the value of any "off-market terms" provided under the new contract. An off-market term is defined as any provision in a contract that is more favorable than what someone who was not exchanging an existing contract would get were they to purchase a similar contract. In the example of the guaranteed minimum death benefit, the off-market term would be the provision of a guarantee that starts out in-the-money at a price that a new policyholder would be charged for an at-the-money guarantee. Another example of an off-market term would be charging a policyholder a premium rate that is appropriate for a younger person. This situation arises when life, disability income, or long-term care policies are replaced, but the policyholder pays premiums based on his or her age at issue of the original policy.

The draft TPA defines the consideration for off-market terms to be the fair value of the differential in contract provisions afforded by the off-market terms. Presumably, this consideration would be established as an additional liability associated with the contract. Use of fair value, however, would likely result in either a gain or loss at replacement because the liability recorded for the benefit on the original contract would not typically match the fair value of the off-market terms established under the replacement contract. In addition, the draft TPA leaves unanswered the question of how, precisely, to calculate the fair value of the off-market terms. It also does not address what to do with the liability for the consideration associated with the off-market terms in subsequent reporting periods.

> ... the consideration paid for the new contract should include not only the cash received upon extinguishment of the old contract, but also the value of any "off-market terms" provided under the new contract.

As with any new accounting pronouncement, it is impossible to predict precisely how practice will develop in accordance with SOP 05-1. In their first attempts to implement the SOP, companies were arriving at different interpretations of the same wording, leading to what appeared to be a diversity of practice from the day the SOP became effective. With the release of the TPAs in February, clarification of several key points has been provided. Hopefully, this means that the inevitable range of practice will be far narrower than it would otherwise have been, leading to a fundamental consistency of application across companies. $

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Thoughts from the Section Chair

by Henry W. Siegel

I'm sitting at my desk looking at the pile of papers I have to read and review. They range in size from 10 pages to the 150+ pages of the Exposure Draft from the IAA's Risk Margins Task Force. Most are in the 50-page range. Almost all were written by actuaries, accountants or insurance regulators.

I have no idea how I'm going to be able to read and comment on all these papers. At the Academy we have about 30 people broken up into three teams reading and commenting on the IAA paper, but even that is proving to be a lot of work for those involved. To think I used to think actuaries tended to write short papers or all in formulas!

Furthermore, as I write this, the IASB has not yet published their Discussion Paper on Accounting for Insurance Contracts. Hopefully, by the time you're reading this they will have. I don't know for sure how long that paper will be, but I've seen a draft of Chapter 6 and it was 30 pages long! This will be one of those must-reads for all financial reporting actuaries since it will affect not only international standards but U.S. GAAP as well. The Academy is setting up another task force to deal with this paper and I hope you've volunteered to help review it! But don't kid yourself: it's not the kind of thing you can review on a train ride (unless, perhaps, you're going from New York to Seattle).

One solution to this problem that is often used is the executive summary. An executive summary should include enough information so that the reader gets the basic logic and recommendations of the paper without reading the entire detailed discussion. Even this is abused, though. I recently received a 75-page paper to review that had a two-page table of contents and a one-paragraph executive summary! The author was an academic who should have known better; apparently he confused an executive summary with an abstract.

So I've invented a new rule just in time for this article: executive summaries should be no longer than 10 percent of the document or five pages, whichever is less. I leave to the reader to solve the question of what to do if you can't say what you want to say in five pages. But I personally am going to spend a lot more time reading and commenting on executive summaries in the future than I am on the body of 75-page papers.

This space intentionally left blank to practice what I preach!

Miscellaneous thoughts:

- About the time you're reading this, some of you (I hope many of you) will have decided to run for council membership. This is a great way to give back to the profession and to have some fun too. Our council will have three new members next year. If you want to run but didn't get your name in by the deadline, call the SOA and see if there's still a chance to enter. If not, try again next year. After all, if you're lucky, you could get to write this column!

- Just as the plural of anecdote is not data, the plural of transaction is not market. More on this next issue, most likely.

- I hope everyone enjoyed the spring meeting. Congratulations to Vincent Tsang, who chaired our efforts and to all the council members who helped recruit speakers.

- If you're planning on going to the annual meeting, look for our joint cocktail party with the Investment Section and our free (yes, FREE!) breakfast for members. We're hoping to have a guest speaker to add to the festivities. Lots of fun and networking opportunities!

These are exciting times for financial reporting actuaries. GAAP and stat are both about to undergo major revamping. There are lots of opportunities for everyone to contribute.

Remember, insurance accounting is too important to be left to accountants!

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NAIC March '07: The Principles-Based Approach Is Coming!

by Donna R. Claire

The March 2007 NAIC meeting was held in my state, New York. As with the last few meetings, the major topic of the Life and Health Actuarial Task Force (LHATF) of the NAIC continues to be principles-based approaches (PBA) to reserves and capital.

SVL2/PBA: I, as chair of the Academy's life effort on PBA, gave an update on the Academy's PBA/SVL2 groups. The technical actuarial work is likely to be completed in 2007; the regulators and the industry need to feel comfortable/make any needed changes with all the proposals before it is implemented.

Economic Scenarios: Larry Gorski gave an update on the Economic Scenarios Working Group, which is developing the basic scenario set/calibration rules which would be used for stochastic testing under PBA. Note that this work will replace the current RBC C3 Phase 1 scenario set. Further details on the Academy PBA projects can be found on *www.actuary.org.*

Preferred Mortality: Larry Gorski gave an update on the joint SOA/AAA preferred mortality study. This work is proceeding. They expect to deliver a set of basic/valuation tables by September.

Valuation Manual Team: Dave Neve, a subteam chair of the Valuation Manual Team, gave an update of the work of his Academy's Valuation Manual Team. This manual is expected to replace regulations and actuarial guidelines. An outline of what the four sub-teams (New PBA Rules, Current Rules, Experience Studies and Low-Risk Products) are working on was presented. There are over 50 volunteers working very hard, and they expect to have a draft of the manual available before the next NAIC meeting. Norm Hill also discussed the low-risk products (i.e., what can be done from day one to accommodate low-risk products?).

LRWG: Dave Neve and Tom Kalmbach, co-chairs of the American Academy of Actuaries's LRWG, gave an update on the Life Reserve Work Group work. They have revised the proposed regulation and actuarial guidelines so it can now be part of the valuation manual. The LHATF voted to expose these drafts. These documents will be available on the Academy Web site, *www.actuary.org*.

VACARVM: Tom Campbell reviewed the Academy comments on the proposed regulation which is currently exposed for comment. The ACLI also provided comments. There is a subgroup headed by Larry Bruning that is working on a survey which was being sent to certain large variable annuity writers to provide more details. Because the survey was already sent out, LHATF voted not to expose another copy of the draft comments at this time.

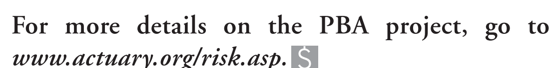
SVL2 Subgroup: Larry Bruning gave an update on his LHATF Subgroup, which has released a draft of proposed revisions to the SVL2. They are planning a conference call before the March LHATF meeting.

Nonforfeiture Improvement Work Group: John McBain gave an update on the work of the Academy's Standard Nonforfeiture Law Group. They had previously provided wording to change the current Standard Nonforfeiture Law to take care of the immediate issue of the change needed in order for PBA reserves to be implemented (i.e., de-link the nonforfeiture and reserve interest rates). This meeting discussed issues related to the long-term solution incorporating new ideas into nonforfeiture.

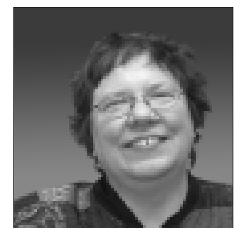
Pre-Need Mortality: Jay Vadiveloo gave an update on the pre-need mortality study being conducted by the Society of Actuaries. Work is progressing, and may be close to a recommended table.

In addition to LHATF, other NAIC groups had discussions on the principles-based approach. This includes the Statutory Accounting Procedures Working Group and a commissioner-level group, called the Principles Reserve (EX) Group, which is shepherding the PBA process though the NAIC. The Life Capital Group is meeting via conference call on the PBA issues.

Major progress has been made on PBA, and the June 2007 NAIC Meeting in San Francisco should advance the PBA project even more.



For more details on the PBA project, go to *www.actuary.org/risk.asp.*



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Letter to the Editor

Douglas S. Van Dam

Dear Editor:

I commend Mr. Lauzon for the thought he has given to the problems with using own credit rating in determining liability values and for sharing those thoughts with us in the December 2006 Financial Reporter. In reading his paper, one gets the impression that SFAS 157 introduces for the first time the use of own credit rating in accounting for the value of a liability. In fact, current accounting standards use credit rating every time a bond is sold.

In the paper's example, Entity B borrows at 12 percent while the risk-free rate is 5 percent. Entity B sells a three-year zero coupon bond for $356. In current accounting, Entity B would get cash of $356 (ignoring transaction costs) and set up an initial liability of $356. This liability would accrue to $500 over the life of the bond. Under Mr. Lauzon's proposal, Entity B would receive cash of $356 but be required to establish a liability of $432, where $432 is the amount that would have to be invested at the risk-free rate in order to accrue to $500 at the end of five years. A loss of $76 would be booked at the time the bond is sold.

Mr. Lauzon states that his method of discounting non-risk adjusted liabilities at the risk-free rate makes it easier to compare companies using the same benchmark, but I think most people understand that if you are borrowing at 12 percent, you had better plan on making more than that or you will not stay in business. Being required to book a non-economic loss of $76 at issue is potentially less understandable than the simple concept of 12 percent annual interest costs.

SFAS 157 describes how fair value is to be measured, but doesn't change which instruments should be measured using fair value. Paragraph 5 of SFAS 157 states "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." That is hard to argue with. Perhaps Mr. Lauzon's argument is closer to an argument that fair value is not a useful measure in financial statements.

FASB has released SFAS 159 on The Fair Value Option for Financial Assets and Financial Liabilities that would allow companies to fair value many more assets and liabilities than is the current practice. In the example above, current accounting uses fair value at issue and then amortized cost after issue. The "interest cost" remains at 12 percent for the life of the bond.

If this bond were carried on the books at fair value, then the interest cost would vary at each accounting period based on current interest rates Entity B would have to pay. For example, if, the day after Entity B sells the bond, world-wide interest rates all increase by 200 basis points, then the value of the bond would go from $356 to $337, a decrease of $19. Entity B would need to decide if its use of the borrowed funds can support a 14 percent interest rate because it has the option to purchase the bonds back at $337 and make an immediate profit of $19. If Entity B does not elect to purchase the bonds back, it is reasonable to say that they now have an interest cost of 14 percent. This would make the value of the bond on its books $337, the market price of the bond.

The controversial aspect of the Exposure Draft is what happens if it is not world-wide interest rates increasing by 200 basis points, but a rating downgrade that causes Entity B's bonds to decrease in value by $19. The math is the same—however, a

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rating downgrade has the potential, in the absence of other changes, to increase the net worth of Entity B by $19 since the fair value of the liability, as determined by the market value, has decreased by $19. Even worse, in fair value accounting this change in the balance sheet goes through the income statement and a rating downgrade is an income-producing event! I don't think FASB likes this result either, but they are potentially allowing it because that is what the math is telling them to do. As mathematicians, we should appreciate that. Disclosure of the source of the $19 will be required.

One area that Mr. Lauzon and I agree on is that liabilities that have a superior claim to resources should be discounted at a rate that reflects the superior claim. I have seen examples from other actuaries where they have tried to incorporate the insurance company's bond rating into the discount rate used to value an insurance liability. Paragraph 6 of SFAS 157 starts with the statement "A fair value measurement is for a particular asset or liability." At a minimum, the discount rate should be based on the claims paying ability.

I would go even further and say that for an insurance contract the best indication we have of market value, or fair value, is the price paid on the day it is issued. This price reflects the superior claim to resources and the credit enhancements of the guarantee association. Depending on the type and size of contract, this could result in a contract that is, from a credit standpoint, essentially risk-free. I will let others argue as to whether my interpretation is consistent with the definition of exit value in SFAS 157, but taking into account the superior claims to resources of the insurance liabilities will reduce the volatility resulting from using own credit rating.

The paper makes the statements that own credit rating is inconsistent with exit value and that fair value exit prices should be independent of the exiting entity. Having made those statements, I wonder if Mr. Lauzon remains comfortable with the current proposed direction of U.S. statutory accounting where the value of liabilities is dependent on the assets backing them. SFAS 157 addresses this by stating "A fair value measurement assumes … that the nonperformance risk is the same before and after the transfer." (Paragraph 15.)

In conclusion, I agree that the market expects to be paid a price when it accepts an uncertain payment. When there is a market value, that price includes both the risk-adjusted expected cash flows and the margin required for accepting the uncertainty of payment. There is no need for an adjustment as proposed by Mr. Lauzon to reflect the uncertainty. In determining the fair value for insurance liabilities our goal should be to develop as nearly as possible a valuation methodology that would get us to a market price. $

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Financial Disclosures—Cleaning up the Confusion

by Lawrence A. Seller

At last year's Valuation Actuary Symposium, a Wall Street investment analyst said that the insurance industry is the last place investors look to for growth. On the surface this is somewhat surprising given that, over the last few quarters, many companies have been reporting record sales and earnings, as well as improvements in other profitability measures. Among the reasons cited were the inconsistency and lack of comparability of our financial disclosures. To better appreciate what he was saying, I took a look at the Q4 2006 disclosures—press releases and statistical information packages—of eight companies. While a great deal more information is presented in the U.S. GAAP 10-K and other analogous statements, as previously noted by Rob Frasca and Gordon Tucker in their article "Financial Statement Disclosure: The Needs and Practices related to Financial Risk," which they presented in the January issue of the *Actuarial Practice Forum*, it is the press releases and supplementary packages that are the primary information sources for the analyst community. I can definitely see why the analysts have such a difficult time with our industry. In fact, before even considering the content of these releases, that results could be presented on a Canadian, European, U.S. GAAP or perhaps some other basis, indicates how hard a job they have assessing the quality of one company versus another.

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The good news is that we, as financial actuaries, possess a broader understanding of our financial results than anyone, and this leaves us uniquely positioned to be a business solution, rather than a traditional worrier about reserve conservatism.

In reviewing the releases, my focus was on the income statements, DAC, reserves and supplementary metrics provided on the variable deferred annuity (VA) business, since it is these figures and the corresponding explanations that the industry is using to give the analyst community a snapshot of how companies are performing. Below are my observations and some purely personal thoughts on what could help. Since content that different people will view as important will vary widely, please note that these observations are strictly subjective. It is also important to keep in mind that this is not about any company in particular; rather, it is about both the consistency among companies and the breadth of disclosure needed to gain maximum comfort among current and potential investors.

Income Statements

While all businesses provide an income statement, and for non-insurance businesses it may be instructive, for a business such as deferred annuities it is somewhat of a waste of space. For starters, a number of lines in the income statement offset each other as all policyholder cash flows are offset by the change in reserves. I would contend that a well documented source of earnings analysis is of far more value to the reader. On the disclosures I read, the source of earnings presentations ranged from well developed to nonexistent. While a U.S. GAAP FAS 97 income statement does provide some information in the form of things like mortality gains, expense gains and surrender gains, I believe more information is needed.

A good example of what a source of earnings analysis can provide is that it can clarify a company's cost of offering guarantees. When FAS 97 was first released, the only major VA guarantee was the GMDB, and its charge was usually bundled into the product's M&E. The FAS 97 income statement does have a line for "mortality gain," but if a company could not unbundle its fees then the true cost was difficult to ascertain, although back then the benefits were far less generous than they are today, and usu-

ally required insignificant reserves. Today's products, however, offer a myriad of guarantees, often with unbundled charges, and with significant reserve requirements. To provide the reader with information on how these guarantees are affecting the VA business would require showing, in aggregate, for each type of guarantee:

- the fees collected on an unbundled basis (which would reduce expense gain), less,
- excess payments made by the company, less,
- the increase in reserve.

Needless to say, when adopting a source of earnings tool, it will be important to provide additional clear and concise information on what each line means. Otherwise the industry will not realize as much gain from this effort as it could since comparability across companies will be too difficult.

Secondly, companies include different items within each income statement account. One example is that trail compensation can be included as either commissions or expenses. When included in commissions, it detracts from the reader's ability to discern what cost the company is incurring to get business on its books; but when it is buried in expenses, it is harder to make conclusions about the company's operating efficiency. The latter is even harder if a company includes both acquisition and maintenance costs in its line for expenses.

An especially complex item for VA business is investment advisory spread (companies use various terms for this amount). This item has two components: fees collected by the fund advisor and fees paid to the fund manager. When included within separate items of revenue and expense, there is again the potential for other metrics to be distorted.

I did see some footnotes discussing where certain cash flow items get included, though this practice was inconsistent.

DAC

From the outset, understanding what we present about DAC, and reserves for that matter, is made infinitely more complicated by the different accounting systems in place. Every system certainly has its merits, but when non-actuarial analysts look to understand one company versus another, it is understandable how this would make them scratch their heads. The ultimate solution to this problem could lie with the developing International Accounting Standards, but until that day comes it is critical to ask ourselves how we can improve our disclosures.

From the outset, understanding what we present about DAC, and reserves for that matter, is made infinitely more complicated by the different accounting systems in place.

By now most analysts should have a pretty good grasp of the concept of U.S. GAAP DAC unlocking. For VAs, good stock market performance will enhance projected fee revenues, thereby allowing for a positive DAC unlocking. Q4 2006 was such a quarter, yet disclosures showed positive, negative and no unlocking impact. Only for non-U.S. companies is the concept not applicable. When negative, one driver cited was an update to assumptions, clearly a valid reason. I believe the key to be that, whenever actual results will not match analysts' expectations, it is crucial that we provide additional information. For example, what was the assumption change and why; and what would the results have been in the absence of this change. Keeping our assumptions confidential is something we hold very dear to our hearts, but could it be that this stance is hurting us in the eyes of the analysts? Without such information, we may be opening the door for them to play devil's advocate and say, "we used the stock market run-up to add some conservatism to our financials, just like actuaries always do."

With record sales come record amounts of new capitalization. It seems logical for analysts to be curious about DAC recoverability, which is something I read very little about. This does not mean we should disclose the k-factors for each issue year tranche of DAC, but I did observe some creative ways of providing recoverability information which would give comfort to analysts.

One exhibit had a breakdown of the single amount shown for DAC into amounts by issue year. This can give comfort that the company's DAC balance is not over-weighted to older durations which have high lapse rates. Some additional information on durational lapse rates would also be helpful to assess recoverability. There is no question that such disclosures could be controversial. Companies with higher lapse rates would undoubtedly be reluctant to dis-

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What's true of DAC is truer of reserves due to both greater complexity and the more numerous rules which must be followed.

close them, but, if they do not and other companies do, then they could be viewed as a less favorable company. What the need to provide such disclosures could do, though, is force a company to make some tough decisions on certain blocks of business. A decision to write-down some DAC could be painful in the short run but advantageous in the long run. The company would have to work with the analysts that cover it in order to have such a decision viewed positively.

An additional observation concerns the new SOP 05-1 on internal replacements. Some U.S. companies did disclose whether this SOP, and its requirement for DAC to be extinguished in some cases, would have an impact on future financial results, while others did not. Any time there is a new development, why not discuss it at the first possible opportunity? If either no impact is expected or we are not yet certain, that's fine, but let's not leave our audience guessing.

Reserves

What's true of DAC is truer of reserves due to both greater complexity and the more numerous rules which must be followed. As we know, it is this item that generates the most confusion, and hence the most cynicism, about the insurance business.

Let's look at just U.S. GAAP. There are FAS 60 and FAS 97 businesses (among others), and VA guarantees are valued using SOP 03-1 in some cases and FAS 133 in others. When you factor in the requirements of other accounting systems, is it any wonder why our business is seen with such confusion? The inconsistency of the information provided in our releases only adds to it. For example, if all companies explained what the key drivers of their reserve change were, then we could begin to peel away some of the mystery surrounding this item.

The hottest product features for life insurance and VAs are the guaranteed no-lapse and benefit provisions that are being offered. As the features that also present the most risk to our companies, aren't we obliged to present as much information as possible about how we are managing these risks, beyond just presenting the amounts of reserves? Not only did breadth of information presented by companies vary widely, but reserves also moved in different directions. One intuitive view for those less knowledgeable about reserves for guarantees would be that strong market performance will lower our VA net amounts at risk, thus allowing our reserves to decline, but we know that this is far too simplistic, with a few of the many possibilities being:

- Under the stochastic analysis used by some companies, it could be that a market run-up will result in declining return scenarios becoming very bad due to their products' step-up feature, and if these scenarios underlie the reserve then the reserve will increase.

- Another possibility is that business is already sufficiently out of the money so that the only reserve action under SOP 03-1 is additional assessment accumulations.

- It could also be that the quarter of a market run-up is being compared to another quarter where market growth allowed business that had been in-the-money to get out of the money, thereby lowering reserves, while the reserves would move little in the current quarter since the business was already out-of-the-money.

- Finally, assumptions could have been updated (see above).

It is in this area where the greatest confusion lies, and we must be proactive in both anticipating what the reader's expectations will be and addressing situations where they do not materialize. In determining what to disclose, it is also important to consider the results of one reserve system or method versus another. Did FAS 133 reserves move in the same direction as the SOP reserves? Where more than one reserve system is presented, were the reserve movements consistent? If the answer is no, let's say why.

Supplementary Metrics

On the positive side, it appears that almost all companies have recognized information shortfalls by providing a number of non-GAAP and/or proprietary financial metrics. I found this to be quite helpful, though the value would be enhanced if some additional information were provided.

For example, many companies provide a figure indicating the value of new business written. Consistent with record sales, this metric is also reaching record levels. However, if this measure has increased by a percent that is significantly greater than the increase in sales, shouldn't an explanation be given? Has the company been able to overcome competitive pressures and increase its margins, or is it simply a matter of economies of scale?

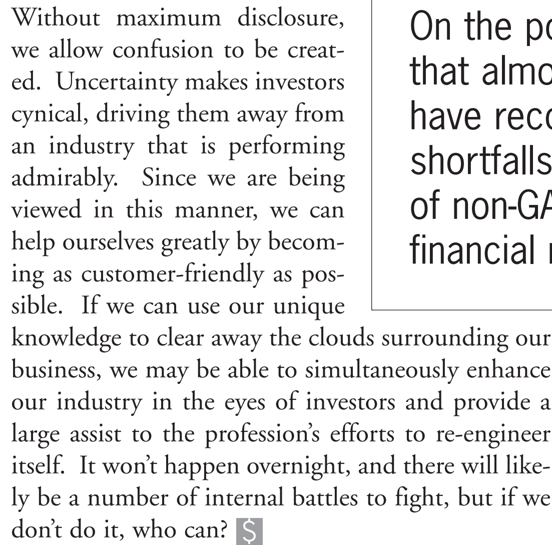
Another simple example is the presentation of commissions. When the period-to-period change does not correspond to the change in sales, it raises the question of what the driver is. Has the company revised its compensation scales or cut back on promotions, or is it just a matter of product mix?

Some additional detail of what is included in an item, such as expenses, would also be instructive.

I also think we need to ask the question of whether we could be inundating the reader with too many numbers when some better disclosures would streamline the presentation.

Conclusion

Without maximum disclosure, we allow confusion to be created. Uncertainty makes investors cynical, driving them away from an industry that is performing admirably. Since we are being viewed in this manner, we can help ourselves greatly by becoming as customer-friendly as possible. If we can use our unique knowledge to clear away the clouds surrounding our business, we may be able to simultaneously enhance our industry in the eyes of investors and provide a large assist to the profession's efforts to re-engineer itself. It won't happen overnight, and there will likely be a number of internal battles to fight, but if we don't do it, who can? $



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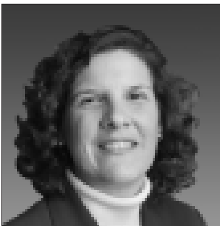
Financial Reporting Section Research Update

by Ronora E. Stryker

Recognizing the need for new information to assist financial reporting actuaries in their daily practice, the Financial Reporting Section Council has recently sponsored new research. In the last issue of the Financial Reporter, Henry Siegel, chair of the section council, introduced members to a new section research initiative. The project examines the impact of the IASB/FASB suggestions outlined in the upcoming discussion paper on accounting for insurance liabilities. While the discussion paper has not been released at the time of this writing, preparations have begun, including assembling a committee led by Tom Herget to oversee the project and work closely with the research team from Pricewaterhouse-Coopers to define the products and issues to be studied. Insurers have also been contacted to help model the suggested accounting changes and many have agreed to contribute their results to the study. Assuming the issuance of the discussion paper is not delayed, it is expected the project will be completed by late third quarter or early fourth quarter of this year.

Another project underway is a result of the section's 2006 open request for research proposals and examines recent developments in the UK regarding market-consistent valuations of life insurance. The UK's Financial Services Authority has established a new requirement for large- and medium-sized life insurers writing participating business to prepare "realistic valuations" of assets and liabilities. In addition to discussing the regulatory developments, this project analyzes how companies have complied with the new requirement, exploring the assumptions utilized, analyses performed and how the results have compared to traditional valuation approaches. The lead researcher, Christopher O'Brien of Nottingham University, has completed the research and is working with section volunteers to finalize the report.



Ronora E. Stryker, is research actuary at the Society of Actuaries, Schaumburg, Ill. She may be reached at rstryker@soa.org.

Principles-based valuation is another topic under study. The project, Analysis of the Z-Factor, is progressing on schedule. The American Academy of Actuaries' Life Reserves Work Group (LRWG) and the National Association of Insurance Commissioners have had considerable discussion regarding a method for measuring the margins for uncertainty utilized in reserves under a principles-based approach resulting in the development of a potential measure known as the Z-Factor. Co-sponsored with the LRWG, this project looks at the validity of the Z-Factor metric. John Roeger of Milliman is heading the research efforts. The questions to be addressed include, but are not limited to, the following:

1. Is the Z-Factor methodology mathematically sound?
2. How sensitive is the Z-Factor to different levels of capital?
3. Does the Z-Factor provide consistent results across all general account life insurance product lines?
4. Is the Z-Factor applicable to separate account products?
5. Under what circumstances would the Z-Factor fail, if any?
6. Are there alternative measures that should be considered?

Look for the research paper to be available soon on the SOA's Web site.

A second project related to principles-based valuation is just beginning. Jay Vadiveloo of the Deloitte-UConn Actuarial Center is analyzing potential capital markets' benchmarks for the purpose of comparing these measures to the spread assumptions used in actuarial models for estimating future net investment returns according to the exposure draft of the Principles-Based Reserves for Life Products Model Regulation and related Actuarial Guidelines.

While you are waiting for the findings of the above studies to be published, peruse the section-sponsored research report on financial statement disclosure practices of life insurance companies by Rob Frasca and Gordon Tucker of Ernst &Young found on the SOA's Web site at: *http://www.soa.org/research/life/research-financial-statement-disclosure-report-the-needs-and-practices-related-to-financial-risk.aspx*.

If you would like more information about any of the above projects or are interested in getting involved in section-sponsored research or have an idea for a research project that would benefit Financial Reporting Section members, please contact Ronora Stryker, SOA research actuary, at *rstryker@soa.org*.

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Thank you for your help.

What's Outside

Reinsurance News

(Reinsurance Section newsletter)
February 2007
http://library.soa.org/library-pdf/RSN0702.pdf

JJ Lane Carroll and other members of the team updated a research project in stochastic analysis. Unlike most stochastic modeling approaches, this one focuses on the volatility in mortality results.

Risk Management

(Joint Risk Management Section newsletter)
March 2007
http://library.soa.org/library-pdf/RM0703.pdf

Matthew P. Clark and Chad Runchey described and compared three approaches to economic capital:

- Fair value, used in Europe, Canada, and Australia, takes a one-year horizon.
- Regulatory (U.S. RBC C3 Phase II), which projects regulatory surplus over many years.
- Cash balance, newly emerging, projects cash flows over the life of the contracts, but unlike the regulatory method, does not consider interim results.

Risks and Rewards

(Investment Section newsletter)
February 2007
http://library.soa.org/library-pdf/RRN0702.pdf

Tom Grondin also looked at economic capital models, using the fair-value definition. He pointed out that that declared insolvency is not equivalent to economic insolvency, and so historic probabilities of default are not appropriate for use in setting confidence intervals for various rating levels. He included an interesting chart that shows his interpretation of economic confidence levels corresponding to various ratings.

CompAct

(Technology Section online newsletter)
January 2007
http://library.soa.org/library-pdf/CSN0701.pdf

Carl Nauman reported on the work of a group developing a standardized file format for communicating economic scenarios. S

Moving Ideas Forward

ANNUAL MEETING & EXHIBIT

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President, Extreme Leadership
GENERAL SESSION SPEAKER

Farber's organization is devoted to the cultivation and development of Extreme Leaders in the business community. Coaching and inspiring Extreme Leadership at all organizational levels is Farber's passion, and he does so with a style that is part strategist, part social commentator, part comedian, and all energy.

JUDY WOODRUFF
Broadcast Journalist, PBS' NewsHour with Jim Lehrer
LUNCHEON KEYNOTE SPEAKER

Woodruff has covered politics and other news for more than three decades at CNN, NBC and PBS. She is currently working on a sequel to her documentary "Generation Next," in which she interviewed young people and reported their opinions, and she is the editor of the NewsHour's 2008 election coverage.

We look forward to seeing you there!

More information about SOA'07 Annual Meeting & Exhibit will be available in the near future at www.soa.org. Registration opens the end of June 2007.

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