



AMERICAN ACADEMY
of ACTUARIES

Practice Note on Anticipated Common Practices Relating to AICPA Statement of Position (SOP) 05-1: Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts

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This practice note was prepared by the Life Financial Reporting Committee of the American Academy of Actuaries. The Academy welcomes your comments and suggestions for additional questions to be addressed by this practice note. Please address all communications to Tina Getachew, Risk Management and Financial Reporting Policy Analyst at getachew@actuary.org.

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Introduction

The practices presented here represent the views of actuaries in industry, consulting and public accounting firms who are involved in implementation of the SOP. The purpose of the practice note is to assist actuaries with application of the SOP. It should be recognized that the information contained in the practice note provides guidance, but is not a definitive statement as to what constitutes generally accepted practice in this area. Actuaries are not in any way bound to comply with this note or to conform their work to the practices described herein. Nothing in this practice note is intended to provide accounting advice. The authors are not accountants. Actuaries should consider the facts and circumstances specific to their situation, including the views of their independent auditors, in making a determination of appropriate practice.

The following accounting documents are referenced in this document. The reader of this document should be familiar with these documents in order to fully understand the effects of the SOP.

- FAS 60 - *Accounting and Reporting by Insurance Enterprises*
- FAS 97 - *Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- FAS 113 - *Accounting and Reporting for reinsurance of Short-Duration and Long-Duration Contracts*
- FAS 133 - *Accounting for Derivative Instruments and Hedging Activities*
- SOP 03-1 - *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long Duration Contracts and for Separate Accounts*
- EITF 92-9 - *Accounting for the present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*
- AICPA Technical Practice Aid 6300.09 - *Reinsurance*
- AICPA Technical Practice Aid 6300.25 - *Integrated/Nonintegrated Contract Features in Applying SOP 05-1*
- AICPA Technical Practice Aid 6300.26 - *Evaluation of Significance of Modification in Applying SOP 05-1*
- AICPA Technical Practice Aid 6300.27 - *Changes in Investment Management Fees and Other Administrative Charges in Applying SOP 05-1*
- AICPA Technical Practice Aid 6300.28 - *Definition of Reunderwriting for Purposes of Applying SOP 05-1*
- AICPA Technical Practice Aid 6300.29 - *Contract Reinstatements in Applying SOP 05-1*
- AICPA Technical Practice Aid 6300.30 - *Commissions Paid on an Increase in Insurance Coverage or Incremental Deposits in Applying SOP 05-1*
- AICPA Technical Practice Aid 6300.31 - *Participating Dividends and the Interaction of Guidance in SOP 05-1 & SOP 95-1*

- AICPA Technical Practice Aid 6300.32 - *Premium Changes to FASB Statement No. 60 Long Duration Contracts in Applying SOP 05-1*
- AICPA Technical Practice Aid 6300.33 - *Evaluation of Changes Under Paragraph 15a of SOP 05-1*
- AICPA Technical Practice Aid 6300.34 - *Nature of Investment Return Rights in Paragraph 15b of SOP 05-1*
- AICPA Technical Practice Aid 6300.35 - *Transition Provisions for FAS 60 Long-Duration Contracts Under SOP 05-1*

This practice note has been divided into six sections:

- Section A: Definition of internal replacement and scope as per paragraphs 8, 9 and 10
- Section B: Integrated/nonintegrated issues as per paragraphs 11 and 12
- Section C: Determining substantial changes issues as per paragraph 15
- Section D: Accounting for contracts that are substantially unchanged as per paragraphs 16 to 24
- Section E: Other issues
- Section F: Examples

Section A: Definition of internal replacement and scope as per paragraphs 8, 9 and 10

All Lines of Business

Q1: Does the legal form of a modification affect the accounting under the SOP? For example, should the following two situations be treated the same for purposes of applying the SOP: (a) adding additional variable investment options to an existing contract through contract amendment; and (b) replacing the contract with a new variable annuity contract where the only difference is additional investment options?

A1: Paragraph A4 of the SOP states that the legal form of the modification should not affect the accounting under the SOP. In part, this paragraph says: "Modifications to contract terms can be achieved through a variety of different legal structures and the form of the modification may be a result of company preference and convenience or regulatory constraints. The Accounting Standards Executive Committee (AcSEC) believes that, in concept, the legal form of a modification should not determine the accounting applicable to the transaction and the accounting should be based on the substance of the transaction, regardless of whether it takes the form of an amendment, endorsement, or rider to the contract or the issuance of a new contract in a contract exchange."

Q2: How is business assumed via acquisition handled under the SOP?

A2: The SOP does not address the initial purchase GAAP but has relevance for accounting for subsequent modifications to the acquired policies. Guidance is provided in footnotes 5, 6 and 7 which are identical and state "If the replaced contract was acquired in a purchase business combination, any present value of future profits established in accordance with EITF Issue No. 92-9, *Accounting for the present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*, should be accounted in a similar manner." Treatment of unamortized balances for present value of future profits (PVP), or equivalently, value of business acquired (VOBA), is then analogous to that for deferred acquisition costs (DAC). This is reiterated in paragraph A16, which states further in regard to acquired business "... paragraphs 16 and 25 of this SOP provide guidance on accounting for other balances associated with the replaced contract." Other balances covered in paragraphs 16 and 25 include reserves arising from SOP 03-1, unearned revenue liability and deferred sales inducement assets. The acquiring company would then account for business acquired through a purchase transaction similar to how it accounts for directly issued business.

Q3: If the purchase GAAP accounting had been set up on a net liability basis, i.e., with no explicit VOBA held, does the SOP apply?

A3: Yes. This is addressed in paragraph A16 that states that, "A respondent to the November 2004 exposure draft requested that the SOP specifically address the accounting implications when the contract is substantially changed and the value of

business acquired (VOBA) is viewed as part of the contract holder liability. AcSEC noted that paragraphs 16 and 25 of this SOP provide guidance on accounting for other balances associated with the replaced contract.”

Q4: How is business assumed via reinsurance handled under the SOP?

A4: Guidance is provided in paragraph A17 as follows: “AcSEC concluded that the reinsurer has a contract with the ceding company, and that is the contract that the reinsurer should evaluate for modifications.” Modifications to a reinsurance treaty would then need to be evaluated by the reinsurer for SOP treatment. Some examples that might arise are as follows:

- The treaty is amended to include an additional block of policies. The reinsurer should consider whether the amendment qualifies as a nonintegrated contract feature under paragraph 13. This could lead to the retention of DAC on the existing block in the establishment of new DAC for those deferrable expenses incurred in acquiring the additional block of policies.
- The ceding company sells its block of business and the treaty is novated to allow the acquiring company to be the new cedant. The reinsurer may want to consider the criteria of paragraph 15 to determine whether the treaty terms are substantially unchanged and whether to retain the current DAC.
- The treaty is amended to reduce the coinsurance percentage on inforce. The reinsurer should consider the applicability of paragraph 15 to determine whether the reduction in coverage results in a substantially changed contract and if not, should refer to paragraph 20 to determine what portion of the DAC should be retained.
- The treaty is amended to convert from coinsurance to yearly renewable term (YRT) and assets are transferred to the ceding company. The reinsurer should consider the applicability of paragraph 15b to determine if there is a substantial change in investment return rights. If so, then the original treaty would be considered to have terminated and the DAC associated with that treaty would be accounted for as any termination would under the appropriate accounting model (e.g., FAS 60, FAS 97). The YRT treaty would be considered as if it were a new treaty and only deferrable acquisition expenses associated with this issuance of the new treaty would be deferred.

Q5: For reinsurance assumed, does the reinsurer ever have to consider modifications to the underlying policies (as opposed to modifications to the reinsurance treaty)?

A5: Yes. Paragraph A17 states that, “AcSEC also concluded that while the criteria in this SOP may not be directly applicable to reinsurance contracts, based on the specific facts and circumstances of a transaction, the concepts are useful in evaluating the

implications on deferred acquisition costs of modifications to reinsurance contracts or the underlying reinsured contracts.” Some potential situations might include the following:

- The treaty covers YRT on a block of term and universal life (UL) for any excess of death benefit over a retention limit. The reinsurer establishes FAS 60 DAC for the YRT treaty. A policyholder converts from term to UL of the same face amount. The underlying policy conversion has no bearing on the amount of reinsurance assumed or the YRT reinsurance premiums. There has been no change to the reinsurance treaty. The reinsurer may see no need to look through to the underlying contract conversion and DAC is retained.
- The treaty covers coinsurance of a block of term and UL. The reinsurer establishes a DAC asset and amortizes it in accordance with FAS 60 for term and with FAS 97 for UL. A policyholder converts from term to UL of the same face amount. The reinsurer would need to consider whether it is appropriate under the SOP to either:
 - Reduce the FAS 60 DAC balance for the converted term policy without increasing the FAS 97 DAC balance.
 - Transfer the FAS 60 DAC balance for the converted term policy to the FAS 97 DAC balance.
 - Leave the FAS 60 and FAS 97 DAC balances unchanged (although this could produce inappropriate results in the extreme case where all or most policies convert).
- The treaty covers coinsurance of a block of term. A policyholder exercises an option that results in a substantial change where this is done within the original contract and meets the test of paragraph 9 for exemption as an internal exchange. If the treaty contemplates this, i.e., allows for ongoing coinsurance of that contract as a matter of course, the reinsurer might conclude that no internal exchange occurred and DAC is maintained. As a practical matter, the reinsurer simply follows the accounting determination of the ceding company. However, if the treaty requires special consideration such as reinsurer re-underwriting or approval, or adjustment to the coinsurance terms, the reinsurer might conclude this was a substantial change and would then extinguish the DAC.

Q6: How is business ceded handled under the SOP?

A6: In any reinsurance transaction, the actuary should first review the requirements of FAS 113 - *Accounting and Reporting for reinsurance of Short-Duration and Long-Duration Contracts*, in particular, paragraphs 14 to 16 that provide guidance on the reporting of assets and liabilities related to reinsurance transactions. This is further emphasized in AICPA Technical Practice Aid (TPA) 6300.09. Although this TPA was issued in regard to SOP 03-1 and not in support of SOP 05-1, some actuaries believe it is applicable to SOP 05-1 applications. That TPA states “*The accounting for reinsurance should be separate from the accounting for the direct contracts of the ceding company in accordance with paragraphs 14 through 16 of FASB Statement No. 113.*” Accounting on a pre-reinsurance basis then directly follows the SOP.

Reinsurance adjustments may include various reserve credits and asset offsets, e.g., contra-DAC offset to DAC for up-fronted reinsurance expense allowances. Some guidance is provided by TPA 6300.09, which states, “*Reinsurance recoverables ... should be calculated using methods and assumptions consistent with those used to establish the direct contract holder’s liability.*” It appears then that accounting for reinsurance adjustments under the SOP generally would follow modifications to the direct contracts as opposed to modifications to the treaty. It is usually prudent to examine the specific facts and circumstances of each transaction to determine the appropriate application of the SOP and FAS 113 to reinsurance.

Q7: If a policy is terminated and replaced by a policy issued by an affiliate of the original issuer, and the criteria (outlined in paragraphs 9 and 10 of the SOP) required to be considered a replacement are met, how would this be treated under the SOP?

A7: According to paragraph A.18, there could be intercompany transactions that could produce a different impact for the parent company and the affected affiliates. Assume a policy in Affiliate A was replaced by a policy in Affiliate B. Assume further that the new policy meets the criteria for “substantially unchanged” with respect to the original policy. From the standpoint of Affiliate A the policy has been extinguished, and Affiliate A’s standalone financial statements should reflect that. But under one point of view, from the perspective of the parent company to the two affiliates, this may be considered a substantially unchanged internal replacement, and thus the parent company’s financial statements should reflect a continuation of DAC under “substantially unchanged” accounting. Therefore, the accounting for the transaction at the parent company level may not equal the sum of the accounting as recorded at the affiliate level.

Another point of view on the situation in the example above is that if a policy in Affiliate A is replaced by a policy in Affiliate B, then this would necessarily be a substantially changed internal replacement. Those taking this point of view believe that is because the two separate legal entities necessarily have different default probabilities, and therefore the nature of the investment return rights differs between the two affiliates. Therefore, a replacement of this type would likely fail the criteria in paragraph 15b requiring that a replacement can be substantially unchanged only if (among other criteria) “the nature of investment return rights...between the insurance enterprise and the contract holder has not changed.” Since the nature of the investment return rights has changed in this situation under this point of view, this replacement would be considered substantially changed for the parent company.

Q8: If there is no DAC (or DAC-like items such as unearned revenue liabilities or deferred sales inducement assets) on a block of policies or line of business, is there anything in this SOP that would apply?

A8: Even though a block of policies may have no DAC or DAC-like items, it is advisable to consider application of SOP 05-1 because it could impact the accounting for subsequent activity on such a block. For example, there may be options or riders that can

be elected by the policyholder in the future and generate acquisition costs that would be accounted for under the SOP.

Also, even if there is no DAC on the existing block, the classification of the exchange under the SOP would impact the potential deferability of costs associated with the exchange.

Further, death benefits or annuitization benefits under SOP 03-1 may be currently so far out of the money as to produce zero reserves; or benefits paid to date may have exceeded the accrued liability, resulting in no current liability. But if future market conditions change, then non-zero SOP 03-1 liabilities may need to be established. The amount of such liabilities may depend on the original classification of the replacement policy under SOP 05-1.

In addition, the SOP guidance needs to be evaluated because, even in the absence of DAC balances, there exists the potential for an impact on recorded liability balances, for example, liabilities under SOP 03-1 for GMDB or GMIB type benefits, unearned revenue and FAS 60 liabilities. See Q39 below for more discussion regarding FAS 60 liabilities for substantially changed contracts.

Q9: Paragraph 9 of the SOP defines four criteria for determining whether an election made by a contract holder constitutes an internal replacement. The first of these states that an election must be “made in accordance with terms fixed or specified within narrow ranges in the original contract” in order for the election not to be deemed an internal replacement. How should “narrow range” be interpreted in this context?

A9: The SOP does not explicitly state what a “narrow range” means. However, by applying the concepts underlying the SOP, one interpretation is that a narrow range is one which would not meaningfully change the nature of the contractual relationship between the insurance company and the contract holder, irrespective of where within that range terms of the contract are set. Paragraph A.7 states that the contractual elections must be "... specific enough that the contract holder is able to evaluate whether to elect the feature..." and "narrow enough to provide a meaningful guarantee ...". A range that is so broad as to enable the insurance company to materially reduce its exposure to a contractual guarantee, or to materially increase the fee it charges for making the guarantee, may not be considered “narrow” under this interpretation of the guidance. For example, for charges that are expressed as a percent of account value, one may conclude that flexibility to alter the charge by more than a few basis points could enable the company to change materially the nature of its guarantee to the policyholder, so a range that exceeds this size (i.e., a few basis points) would not meet the definition of “narrow.” Similarly, one may view any provision that allows the company to establish the charge for a benefit feature at some future election date rather than guaranteeing it at contract inception as one that would not pass this interpretation of a "narrow range" test.

Q10: Is it possible to meet the conditions in paragraphs 9a, 9b and 9c but fail to meet the condition in paragraph 9d?

A10: Several respondents to exposure drafts of the SOP expressed the view that paragraph 9d is not an independent criterion for determining whether a modification is an internal replacement, but rather a consequence of the other criteria. Although AcSEC did not comment on this point in the Basis for Conclusion section of the SOP, paragraph 9d was retained in the SOP. One interpretation would view paragraph 9d's role as adding emphasis to the points established in paragraphs 9a, 9b, and 9c, rather than as an independent criterion. It provides an additional way of thinking about the criteria that may give a clearer route than any of the other three in determining that a contract modification is not an internal replacement. Under this view, it may not be possible to fail the condition in paragraph 9d without failing to meet at least one of the other three conditions as well.

A counterargument to this position is that a contract feature could exist from contract inception without any liability having been established for it. In such a situation, one could argue that the feature was not "accounted for" since contract inception, thus failing to meet the condition under paragraph 9d. Others, however, take a broader view of the term "accounted for" and take it to mean "considered." In this view, a contract feature would have been "accounted for" since contract inception, as long as it was considered in the establishment of the accounting policy when the contract was written. "Considered" does not necessarily mean that an actuary calculated a reserve and found it to be zero or immaterial, but could include situations where it was determined that an explicit inclusion of the specific benefit feature was not necessary. The example given in the SOP of a feature that is not accounted for under FAS 133 treatment because of the grandfathering provision of that Statement seems to support this view.

Q11: The SOP glossary defines a contract exchange as the "legal extinguishment of one contract and the issuance of another." Does this mean any new issue is automatically an internal replacement if the policyholder had a prior policy with the company which has since been surrendered ("extinguished")? And, if so, how far back would the company need to check?

A11: The wording of the SOP implies that the legal extinguishment of one contract and the issuance of another occur simultaneously. In practice, this may not be the case. In applying the SOP, the actuary should consider whether contract exchanges include situations where there is an operational time delay between termination of the old contract and issuance of the new contract. There are no specific requirements in the SOP regarding a reasonable time delay. However, where the transactions are not simultaneous, the actuary may consider whether some evidence of linkage (e.g., that the terms of the replacement contract were fixed and guaranteed at the time that the prior contract was surrendered and that conversion to the replacement contract had been irrevocable) is needed to distinguish an exchange from independent transactions of surrender and new purchase. As a corollary, it does not appear that a company could choose to merely hold off issuing a replacement contract for a certain time period to avoid treatment as a contract exchange under the SOP.

Q12: How does one distinguish a contract exchange from a surrender of a policy followed by a subsequent unrelated new purchase?

A12: Paragraph A4 states “... the accounting should be based on the substance of the transaction, regardless of whether it takes the form of an amendment, or rider to the contract or the issuance of a new contract in a contract exchange.” Where modification to the contract terms is effected by a contract exchange, as an alternative to modifying the existing contract or by adding a rider, the SOP requires that these be treated as internal replacements. The company would need to be able to identify substantially all policies that have been or are in the process of being exchanged in order to meet the requirements of SOP 05-1.

Q13: Certain reductions in benefits required by state law or regulation are not considered internal exchanges. By analogy, would changes as a result of other official directives such as court ordered modifications be considered internal exchanges?

A13: Paragraph 10 states that partial withdrawals, surrenders, or reductions in coverage are not internal replacements where these occur either by terms as of inception of the contract, or “if required by state law or regulation, at terms in effect when the reduction is made.” The SOP appears to endorse the concept of substance over form, for example, stating in paragraph A4 that “the legal form of a modification should not determine the accounting applicable to the transaction and the accounting should be based on the substance of the transaction.” Some actuaries conclude from this that other official directives, for example, federal law or state bulletins, should be viewed in a similar manner. Other official directives might include court ordered changes such as remedies to policyholders for market misconduct, or court ordered revised benefits under a structured settlement case, or state approval of a health plan rate increase where the company must provide the policyholder the option of paying either the higher premiums or unchanged premiums but with reduced benefits. It would appear important that in all these cases, “the terms in effect when the reduction is made” should be as set by the official directive and not by the company.

Paragraph 10, however, is specific in that it only applies to reductions in coverages. Therefore, it is not clear whether extending this to increases in coverage is acceptable under the SOP

Q14: Under the SOP, how is a modification accounted for if a policy form is altered to account for changes necessitated by regulatory action? For example, what happens if benefits and premiums need to be changed on a Medicare supplement policy because Medicare benefits have changed?

A14: One interpretation is that the revision of the policy to comply with new regulation would not constitute a contract modification because of language in paragraph 10. However, this sense is conveyed in a relatively narrow discussion in paragraph 10, which applies specifically to partial withdrawals, surrenders, and reductions in coverage. This

could lead to a different interpretation that the determinations made under the SOP are independent of the motivation, regulatory or otherwise, that gives rise to them, with the exception of reduced coverages addressed in paragraph 10. Yet another view, is that the relatively narrow applicability of paragraph 10 notwithstanding, changes motivated by regulatory requirements might not constitute internal replacements at all insofar as they can be analogized to guaranteed renewability and/or the implied right within any contract of the regulatory authority to alter its provisions in the interest of public policy. The actuary should consider circumstances such as whether there is a new negotiation between the company and the policyholder at the time of the change. If so, it may be reasonable to conclude that the transaction would constitute a termination of the old contract and the issuance of a new contract.

Some actuaries believe that the annual benefit change due to Medicare Part A deductible changes does not trigger an internal replacement. However, a change such as dropping Med Supp drug coverage due to Medicare Part D may require more consideration. The actuary may need to determine if this is a change that would trigger treatment as an internal replacement.

Annuity Business

Q15: Does the addition of a death or living benefit (GMAB or GMWB) to an existing variable annuity contract constitute an internal replacement?

A15: This determination can only be made with reference to the specific facts related to the particular product features under consideration. However, adding a GMAB or a GMWB to an existing variable annuity contract under which no such provision existed previously, typically would constitute an internal replacement because some or all of the following conditions outlined in paragraph 9 would not have been met:

- “The election is made in accordance with terms fixed or specified within narrow ranges in the original contract
- The election of the benefit feature, right, or coverage is not subject to any underwriting
- The insurance enterprise cannot decline the coverage or adjust the pricing of the benefit, feature, right, or coverage
- The benefit, feature, right, or coverage has been accounted for since the inception of the contract....”

In order to conclude that the internal replacement resulted in a substantially changed policy, a determination would likely be made as to whether the nature of the investment return rights had been changed as a result of the addition of the living benefit (paragraph 15.b), assuming the other conditions of paragraph 15 are satisfied. For a typical GMAB or GMWB that has been added to a variable annuity without such benefit previously, the

conclusion that a substantial change has occurred would likely be supported. Paragraph A30, TPA 6300.34 and the examples in paragraphs B.39 to B.41 support this conclusion.

Q16: If my company offers a deferred annuity with a death or living benefit that is an elective benefit in the original contract with defined pricing, would election of the benefit be considered an internal replacement?

A16: If all of the requirements of paragraph 9 are met, then the election of such a benefit would not constitute an internal replacement subject to the guidance of the SOP. Although there may not have been a value recorded for the benefit prior to election (i.e., because the value has been determined to be zero or immaterial), the actuary should consider whether the benefits have been accounted for since inception of the contract, thereby satisfying the criterion of paragraph 9d. The actuary should also consider the discussion in Q/A10 in this document.

Q17: Would the election of an annuitization option within a deferred annuity contract result in a change in accounting treatment due to the SOP?

A17: Existing GAAP guidance (e.g., FAS 60 and FAS 97) already requires that an annuitization be treated as a new contract. In particular, the last two sentences of paragraph 7 of FAS 97 state, "A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms." The actuary may want to consider the last sentence of paragraph 9 and footnote 4 of paragraph 16 that appear to reemphasize this point.

Individual Health Business

Q18: How is a rate increase on a guaranteed renewable contract (e.g., long-term care or individual disability income policy) treated under the SOP?

A18: The actuary should consider the requirements of paragraphs 9 through 15 to make a determination on the treatment of rate increases on a guaranteed renewable contract. Some actuaries believe that as long as the guaranteed renewability feature is clearly established within the contract, a rate increase across an entire class of policyholders does not constitute a contract modification and, consequently, is not an internal replacement subject to the guidance of the SOP.

Q19: On individual health insurance policies, it is common practice to replace an existing policy with a new policy when a change in benefits is elected by the policyholder. Does this constitute the extinguishment of the initial contract?

A19: As discussed in Q/A1 in this document, the SOP suggests that the legal form of the modification shouldn't determine the accounting. Thus, the answer to this question depends upon the facts and circumstances of the situation. However, the issuance of a

new contract as part of a benefit enhancement or reduction does not *per se* result in the extinguishment of the original contract in the context of the SOP. This is discussed in paragraph A.4 and the actuary should review this guidance in determining how the SOP would apply in specific circumstances.

Q20: On long-term care contracts, a policyholder is often given the option of receiving reduced benefits in return for premium rate stability in the face of a pending premium rate increase. Does acceptance of lower benefits in such a situation constitute a contract modification?

A20: The actuary should consider whether the requirements of paragraph 9 have been satisfied with regard to the specific situation. If it has been determined that the conditions in paragraph 9 have been met, and the option to receive reduced benefits in exchange for keeping premiums level is provided for in the original contract, some actuaries may conclude that: (1) the election of this option does not constitute a contract modification under the SOP; and (2) the action would not be an internal replacement subject to the provisions of the SOP. If a contractual provision is not present, then the actuary may conclude that the transaction is an internal replacement. However, paragraph 15c states that a reduction in benefit or coverage does not necessarily mean that a replacement contract is substantially changed, provided that the premium is reduced by an amount commensurate with the reduction in coverage. It is ordinarily prudent to review paragraphs B.21 and B.22 in these situations.

Group Business

Q21: Does the SOP apply to group business or make a distinction between the individual certificate holder and the group contract holder?

A21: In some circumstances the provisions of the SOP would be applied at group contract level and in other circumstances the provisions of the SOP would be applied at the individual certificate level. According to paragraph A.29, “the evaluation of all the related facts and circumstances of a group contract is required to determine whether a contract should be analyzed at the group contract level or individual certificate (under the group contract) level for purposes of applying the guidance in this SOP.”

Q22: Are rate increases for group long duration guaranteed renewable business considered within the scope of the SOP?

A22: This question is specifically addressed in TPA 6300.32. The third paragraph of the reply in this TPA states:

The right to adjust premium rates for group long-duration insurance contracts generally would not meet the definition of a modification under paragraph 8 of SOP 05-1 as long as all of the following conditions are met:

- The right to adjust premium rates is provided for under the terms of the insurance contract,
- The change to premium rates for a contract holder is the same change in premium rates that is applicable to the entire class of contract holders,

- Changes to premium rates do not involve consideration by the insurer of specific experience of the contract holder, and
- No other changes in benefits or coverages occur.

Based on this, some actuaries have concluded that for group long duration guaranteed renewable business, rate increases as allowed under the terms of the contract would not meet the definition of a modification under paragraph 8 as long as the above conditions are satisfied. Similarly, changes to premium rates, which are based on a formula specified in the contract and do not involve insurer discretion, would not be considered a modification under the SOP as discussed in the TPA.

For premium or benefit changes that involve a subjective review of the actual experience of the contract holder or the renegotiation of rates or benefits with the contract holder, even if no reunderwriting has occurred, the actuary should review the last paragraph of TPA 6300.32 for guidance. Using that guidance, some actuaries have concluded that this generally would be considered a modification that is subject to the guidance in SOP 05-1.

For group long duration application of SOP 05-1, the actuary should review TPAs 6300.28 and 6300.32 which contain guidance relevant to group reunderwriting and rate increases in addition to the SOP.

Section B: Integrated/nonintegrated contract feature issues as per paragraphs 11 and 12

All Lines of Business

Q23: What is the difference between integrated and nonintegrated contract features?

A23: For long-duration contracts, paragraph 11 defines integrated contract features as those for which the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the base contract. Nonintegrated contract features are those for which the determination of benefits provided by the feature is not related to or dependent on the account value or other contract holder balances of the base contract. For many benefit features, these definitions can be clearly applied. However, some transactions may include benefit features that could possibly fit both definitions, while other transactions do not appear to meet either definition. Paragraph 11 goes on to say that underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the base contract. It is also typical that nonintegrated contract features are accounted and/or reserved for separately. The guidance in TPA 6300.25 suggests that for those transactions where integrated/nonintegrated is not clear, the intent of the SOP is that if there is not separate pricing or reserving of a benefit feature in these situations, it should be considered an integrated contract feature. This can be seen in the first paragraph of TPA 6300.25, which states:

The flowchart in Appendix C, Flowchart - Application of SOP 05-1 Accounting Model, asks the question “Does the contract modification involve the addition of or changes to a nonintegrated contract feature?” If the answer is “Yes”, the non-integrated contract feature is evaluated separately from the base contract. All other modifications need to be evaluated to determine if the contract modification results in a substantially changed replacement contract in accordance with the criteria in paragraph 15.

TPA 6300.25 also adds, "When applying the guidance in SOP 05-1 to determine whether a feature is integrated or nonintegrated, one indicator of a nonintegrated contract feature is that it is distinguishable as a separate component from the base contract."

Q24: Paragraph 11 defines nonintegrated contract features as “those for which the determination of benefits provided by the feature is not related to or dependent on the account balance or *other contract holder balances* of the base contract.” (emphasis added). What are some examples of “other contract holder balances” that could affect the classification of integrated contract features versus nonintegrated contract features under paragraph 11?

A24: Depending on the structure of the contracts in question, “other contract holder balances” might include the face amount, cash value or death benefit available in the contract.

Under some circumstances, the ongoing premium amount specified in the contract could be considered an “other contract holder balance” under the SOP. Whether or not such premiums are considered to be “other contract holder balances” could be one of the factors in determining whether a disability waiver of premium rider added to a contract would be considered an integrated contract feature under the SOP. If premiums are fixed in the contract, then it is not likely that adding a benefit based on this fixed schedule would be considered to be an integrated contract feature, assuming all other conditions are met.

Specific premiums payments such as the initial deposit or cumulative premiums could also be an “other contract holder balance” under certain contract designs where such amounts are used for defining certain contract benefits such as minimum return guarantees. Whether or not a specific premium or cumulative premiums is considered an “other contract holder balance” could determine whether addition of a benefit that depends on such amount would be considered an integrated contract feature under the SOP. Similar to the above example, if a benefit is added that is based on a fixed amount, even if that amount was originally at the discretion of the policyholder, then it is not likely that this would be considered to be an integrated contract feature.

Q25: What are some examples of integrated and nonintegrated contract features?

A25: The most common examples of integrated contract features are the minimum guaranteed benefits attached to variable annuity contracts, such as guaranteed minimum

death benefits and guaranteed minimum withdrawal benefits, as the benefits for these contract features depend on the account value of the base contract. Waiver of premium for UL policies, where the benefit is current charges that include cost of insurance charges as opposed to waiving a target premium, is another example of an integrated contract feature because current charges are a function of account value and death benefit amount of the base contract.

Nonintegrated contract features are more numerous. These would include typical features such as accidental death benefits, term riders, LTC riders and other types of waiver of premium not included in the integrated contract feature examples above. For these contract features, the benefits are usually not dependent on the base contract so they are nonintegrated. However, it may be possible that different versions of these benefit features could be integrated if it is determined that the benefit amount can only be determined by reference to the base policy.

Q26: What happens if a benefit is added to an existing long-duration health contract and no additional premium is charged for the feature?

A26: Each situation would have to be reviewed in light of its particular facts and circumstances by consideration of paragraphs 9 through 14. The addition of a feature on a long-term care or other health insurance contract may be considered to not be integrated with the main contract if it has been determined that the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the base contract. Therefore, the original contract would be accounted for as previously, with the new feature accounted for independently as a benefit for which no recurring premium is charged. The fact that the new benefit and the existing benefit are predicated on the occurrence of the same insured event does not imply *per se* that the contract features are integrated. If, however, the benefit is considered to be an integrated contract feature, it would need to be evaluated under paragraph 15.

Q27: Is a face amount increase to a UL/VUL contract that is considered to be an internal replacement under the SOP an integrated or nonintegrated feature?

A27: The example in paragraphs B.7 and B.8 are for a face amount increase of an Option A (a.k.a. Option 1) type death benefit. Paragraph B.8 indicates that a face amount increase to an Option A death benefit is an integrated feature. There is not an Option B example in the SOP. One conclusion might be that face amount increases to Option B contracts should follow the same accounting as increases to Option A contracts under the rationale that the section 7702 tax death benefit corridor in both Option A and Option B contracts renders both as integrated. Another conclusion is to consider face amount increases to Option B contracts as nonintegrated because the increased amount is not dependent on the account value of the base contract. In coming to such a conclusion, one consideration is the integration of the added face amount with the original account balance and face amount resulting from the section 7702 tax death benefit corridor and whether this is material enough to warrant treating the increase as “integrated.”

Section C: Determining substantial changes issues as per paragraph 15

All Lines of Business

Q28: Do the requirements of paragraph 15b, regarding a change in the nature of investment return rights, include "degree" of change as change in the insured risk requirements in paragraph 15a?

A28: Paragraph 15b does not mention degree or significance of the change in investment return rights. Therefore, a literal reading of the SOP might suggest that no such assessment of degree is necessary with respect to investment return rights. This view holds that certain actions, like the addition of a minimum interest rate guarantee, fundamentally changes the nature of the investment reward rights and therefore should be viewed as a substantial change to the contract without reference to the implied economic value of the change. Paragraph A.30 and TPA 6300.34 contain language that support the view that fundamental changes to the interest crediting mechanism are always a significant change. However, both references provide guidance that changes in the parameters affecting investment returns need to be evaluated for significance.

Q29: Would a change in the guaranteed interest rate on a contract that currently credits a rate in excess of both the original guaranteed rate and the new guaranteed rate result in the contract being classified as “substantially changed”?

A29: There are six criteria that must be satisfied for a contract to be considered “substantially unchanged,” as outlined in paragraph 15. Paragraph 15b states that, the nature of the investment return rights must not have changed. One potential argument under this criterion is that the *nature* of the investment return rights does not change when one guaranteed minimum interest rate is replaced by another, even though the materiality of the guarantee is different. This line of reasoning may lead to a conclusion that the contract is substantially unchanged. A different reading of the term “nature,” as contemplated in paragraph 15b and discussed in paragraph A.30, is that a change in guaranteed rate needs to be evaluated in order to determine the likelihood of the guarantee coming into play in future crediting rates. If the likelihood that the change in minimum guaranteed rates would significantly affect future crediting rates is remote, then such a modification would not be a substantial change. If the change in minimum crediting rates is likely to affect future crediting rates, then some actuaries believe that the contract now credits interest based on a formula (at least under a material number of potential scenarios), so the nature of the guarantee has changed and the requirements of paragraph 15b are not met.

UL/VUL Business

Q30: Is the replacement of an Option A contract with an Option B contract (or vice versa) considered a substantial change?

A30: Some universal life contracts pay a death benefit equal to the face amount, regardless of the account balance in the contract at the time of death. These contracts are often referred to as “Option A” or “Option 1” universal life contracts. Other contracts pay a death benefit equal to the face amount plus the account balance at the time of death. These contracts are often referred to as “Option B” or “Option 2” universal life contracts.

One interpretation is that the replacement of an Option A contract with an Option B contract is an internal replacement under the SOP (unless the provisions of paragraph 9 are met), and is an integrated benefit under the SOP. This would be analogous to a face amount increase. Thus, it would not constitute a substantial change if “only the additional face amount has been underwritten during the contract amendment” and if “the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained,” as outlined in paragraph B.8. Of course, the actuary needs to be certain that the other conditions in paragraph 15 (and described for this example in paragraph B.8) are met.

Conversely, the replacement of an Option B contract with an Option A contract could be considered a “reduction in coverage” under paragraph 10. Thus, they would not constitute internal replacements subject to the guidance of the SOP, so long as the modification was “allowed by terms that were fixed and specified at contract inception...”

Annuity Business

Q31: For a contract that meets the criteria for an internal replacement, in what instances might a reduction in benefits (such as dropping an optional rider) result in the contract being classified as “substantially changed”?

A31: There are six criteria that must be satisfied for a contract to be considered “substantially unchanged,” as outlined in paragraph 15. One of those states that if there is a reduction in benefit, there must be a corresponding reduction in premiums. Otherwise, the change in coverage could result in a substantially changed contract. Also, if the dropping of a rider is considered to “change the nature of investment return rights and rewards,” the contract could be considered substantially changed even if there is a corresponding reduction in premiums. Note that if the ability of the policyholder to drop the rider is provided within the original terms of the contract, then the actuary should review the requirements of paragraph 10 to determine whether or not the policyholder’s election to drop the rider would constitute an internal replacement transaction.

Q32: If an annuity contract has a non-contractual ability to re-initiate the guaranteed rate along with re-initiation of the surrender charge period, would such an election be considered a “substantial change”?

A32: There are six criteria that must be satisfied for a contract to remain “substantially unchanged,” as outlined in paragraph 15. One of those states that the nature of the investment return rights must not have changed. Some actuaries believe that a change in the underlying guaranteed rate, assuming it is a material change, would result in a substantial change because they believe that the nature of the investment return rights have changed. See the comments in Q/A28 above for more discussion on this point. Also, as described more fully in the answer to Q41 below, re-initiation of the surrender charge period by itself does not necessarily result in a substantially changed contract under paragraph 15.

Q33: If a variable annuity contract holder with a GMWB rider exchanges the rider for a GMAB rider, would this be considered a “substantial change”?

A33: There are six criteria that must be satisfied for a contract to remain “substantially unchanged,” as outlined in paragraph 15. One of those states that the nature of the investment return rights must not have changed. TPA 6300.34 states that a change from a GMWB to a GMAB is a change in the nature of the investment return rights, and therefore would result in the contract modification being considered a substantial change.

Q34: Would the exchange of a contract with a guaranteed minimum death or living benefit that is far out of the money for a contract with no guarantee be considered a “substantial change”?

A34: If the contract holder has the right to drop the coverage under the terms of the contract, the transaction may not be subject to the guidance as described in paragraph 10. There are six criteria that must be satisfied for a contract to remain “substantially unchanged,” as outlined in paragraph 15. Criterion 15b is that the nature of the investment return rights must not have changed. One interpretation is that a change from a contract with a guarantee, even if it is out of the money, to one with no guarantee is a change in the nature of the investment return rights, and therefore would result in a substantial change. However, other actuaries have a different view that suggests that consideration should be given as to whether the nature of the investment return rights really changes when the likelihood of a minimum return guarantee paying off is remote, as may be the case under a contract with a guarantee that is significantly out of the money.

Individual Health Business

Q35: What if benefits are changed in connection with a rate increase under a guaranteed renewable contract?

A35: Please refer to Q/A20 in this document regarding benefit reductions in lieu of a rate increase. For benefit increases, the actuary should make a determination if the modification is in scope under the SOP by considering whether or not such change is within a narrow range allowed under the original contract provisions, as well as the other requirements in paragraph 9. For contract modifications that satisfy these requirements, the change in benefits does not constitute a contract modification and the action is not an internal replacement subject to the SOP. On the other hand, if the modification is outside of the range contemplated within the original contract, then the modification would have to be assessed to determine (a) whether it is integrated or nonintegrated with the original contract under paragraphs 11 and 12; and (b) if integrated, whether the contract is substantially changed per paragraph 15. For individual health policies, one might expect the feature to be nonintegrated because health policies typically do not have benefit features that are a function of contract holder balances. However, each situation would have to be assessed individually depending on the particular facts and circumstances.

Group Business

Q36: Does the annual (or other periodic) repricing of group business constitute a substantial change in the context of the SOP?

A36: See Q/A22 regarding when a rate increase on a group guaranteed renewable long duration is considered a modification under the SOP. For a premium change on a group long duration contract that is considered to be a modification under the SOP, a determination must be made as to whether the repricing/rate reset mechanism under the contract constitutes “reunderwriting” as contemplated in paragraph 15a. Other requirements of paragraph 15 must also be considered. TPA 6300.28 states that a subjective review of actual experience is a renegotiation of the contract and essentially includes all of the aspects of reunderwriting.

Section D: Accounting for contracts that are substantially unchanged as per paragraphs 16 to 24

All Lines of Business

Q37: How are deferrable renewal commissions treated on substantially unchanged policies?

A37: Renewal commissions on a substantially unchanged policy would be deferrable up to the level that would have been deferred in the original contract according to its original terms, to the extent such commissions meet the deferability requirements of FAS 60 or FAS 97. Any commissions in excess of that amount would have to be expensed as incurred. Paragraph 22 states, “The portion of renewal commissions paid on the replacement contract that meets the criteria for deferral in accordance with the provisions of FASB Statements No. 60 and No. 97, as appropriate, *limited to the amount of the*

future deferrable renewal commissions on the replaced contract that would have met the deferral criteria, continues to be deferrable under the provisions of FASB Statements No. 60 and No. 97” (emphasis added).

There is a related issue regarding situations where there was a benefit increase to a policy, and expenses were incurred directly related to the benefit increase, but despite the benefit increase the modification leaves the original policy “substantially unchanged.” While literal reading of paragraph 22 may be interpreted to imply that the expenses associated with providing the benefit increase should not be deferred, TPA 6300.30 suggests that paragraph 22 did not intend to limit deferral of the expenses directly related to a benefit increase, and that limiting deferral in this manner can create inappropriate differences in accounting results between similar transactions (for example, increasing the face amount of a UL contract versus purchasing an additional UL contract for the incremental face amount). Costs directly related to a benefit increase remain eligible for deferral.

Section E: Other issues

All Lines of Business

Q38: What should a company do with an SOP 03-1 liability for a contract that is determined to be substantially changed under the SOP?

A38: Paragraph 25 states that, “Other balances associated with the replaced contract, such as any liability for GMDB or GMIBs, should be...accounted for based on an extinguishment of the replaced contract and issuance of a new contract.” The liability would be released even if the replacement contract were to provide a benefit of higher value than the contract being replaced. The actuary should be aware that in this situation the net liability could decrease as a result of the internal replacement despite the potentially increased benefit. That could occur if the SOP 03-1 liability on the replaced contract is greater than the DAC.

A differing view shared by some is that the consideration paid for the new contract should be calculated and include all benefits associated with the original contract. That is, the value in the old contract is part of the initial consideration used to purchase the new contract. If this consideration is greater than the account value liability, some believe that an unearned revenue liability would need to be established for the new contract with the initial unearned revenue liability equal to the difference between the calculated value of the old contract and the account value of the new contract.

Q39: How should reserves on FAS 60 contracts be treated on internally replaced contracts that are substantially changed?

A39: Paragraph 25 states that, “an internal replacement that is deemed to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract...” Some actuaries interpret this paragraph to require that the reserve on a FAS 60 contract that is substantially changed be written off (along with the DAC and other balances associated with the contract). Under this interpretation, a new reserve would need to be established based on the characteristics of the new contract, as if that contract were newly issued. The actuary should be aware that in this situation the net liability (liabilities minus DAC) could decrease as a result of the internal replacement.

A differing view shared by some actuaries is that the consideration paid for the new contract should be calculated and include all liabilities associated with the original contract. That is, the value in the old contract is part of the initial consideration used to purchase the new contract. The calculated value of the old contract would be treated as premium revenue at the inception of the new contract and would be included in calculating the net premium in determining the initial liability for the new contract.

Q40: Should projected EGPs on UL contracts contemplate future internal replacement activity under the SOP?

A40: Some actuaries believe the impact of expected future internal replacement activity not already included in their lapse assumptions should be reflected in estimated gross profits (EGPs) under FAS 97. Those holding this opinion also believe if it is expected that there will be future modifications to the policy that will be treated as substantially changed internal replacements, the lapse assumption used to project EGPs should reflect that expected activity. Alternatively, other actuaries believe that if future modifications are generally evaluated on their own merits and if such modifications are not a reflection of the company’s current best estimate, then such modifications should be not be included in the lapse assumption.

Section F: Examples

The following are examples of contract modifications and the application of the guidance in the SOP for evaluating whether the internal replacements are substantially changed from the replaced contracts. The conclusions reached are based on the specific facts and circumstances of the examples; the same conclusions may not be reached for other modifications because of differing facts or circumstances.

All Lines of Business

Q41: Would adding or restarting the surrender charge period of a contract (if not specified in the original contract) result in a substantially changed contract?

A41: After assessing whether the modification is in the scope of the SOP and, if so, that the modification has been determined to be integrated, the actuary should review the modification under paragraph 15 to determine whether or not the contract is substantially changed. Merely restarting or revising the terms of the surrender charge, without affecting the account balance or other provisions of the new or revised contract, would not appear by itself to be a substantial change since the provisions of paragraph 15, including 15d, have been satisfied. The revision or restarting of the surrender charge only affects the cash surrender value, not the account balance. As long as there is an account balance, changes that only affect the cash surrender value do not appear to affect whether or not a substantial change occurred. Actuaries should review the example in Appendix D as one specific example where a change in the surrender charge period did not result in a substantially changed contract.

Q42: Would adding a persistency bonus (if not specified in the original contract) to an existing contract result in a substantial change?

A42: Persistency bonuses are typically viewed as enhancements to the investment returns realized under an insurance or investment contract. This view is supported by SOP 03-1 (in Paragraphs 37 and A.51, for example). Therefore, in determining whether or not the addition of a persistency bonus results in a substantially changed contract, the criterion contained in paragraph 15b of SOP 05-1 may be relevant. Specifically, the actuary should consider whether the persistency bonus changes the nature of the investment return rights of the contract by virtue of either its size or the characteristics of the bonus. Paragraph 15e may be relevant as well, to the extent that the bonus affects the participation characteristics of the contract. For a typical persistency bonus of modest size, it would not appear that the impact on these criteria would be substantial enough to result in a conclusion that the contract has been substantially changed. However, a conclusion can only be reached by interpretation of the exact specifications of the persistency bonus under consideration.

Q43: Would a change in the premium paying period (if not specified in the original contract) of a contract result in a substantial change?

A43: Some actuaries believe that a change in the premium paying period would not result in a substantial change as long as it is accompanied by a change in the amount of premium, calculated such that the old and new premium streams are actuarially equivalent using reasonable assumptions.

Traditional Life Business

Q44: Would the change of a policy's status from smoker to non-smoker be considered a substantially changed contract under the SOP if the company asked for evidence that the insured no longer uses tobacco?

A44: The SOP provides that reunderwriting an entire contract “generally would indicate a substantial change resulting from a change in the kind or degree of mortality, morbidity, or other insurance risk” (paragraph A.27). In determining whether changing a policy status between smoker and non-smoker constitutes “reunderwriting” in this context, considerations might include: (1) the extent to which the company uses information specific to the use of tobacco in determining whether they will permit the change from smoker to non-smoker; (2) the extent to which judgment is required on the part of the underwriter; and (3) the extent to which there are fundamental changes in the pricing of both smoker and non-smoker rates at the time of the change. TPA 6300.28 states that the performance of examination procedures with respect to specific risks or components of a contract would not represent underwriting or reunderwriting as long as the procedures are limited in nature and do not involve judgment or discretion with respect to acceptance or price.

Q45: How does the SOP apply to re-entry term?

A45: In a re-entry term policy, the policyholder can be reunderwritten at the end of the premium guarantee period to avoid being charged ultimate premium rates. Paragraph A.27 provides that “Reunderwriting the entire contract generally would indicate a substantial change resulting from a change in the kind or degree of mortality, morbidity, or other insurance risk.” Thus, a re-entry term might be considered a substantial changed internal replacement.

Q46: How does the SOP apply to modifications from term to par WL?

A46: A term insurance contract generally is a nonparticipating contract and, even if it is a participating contract, dividends are generally not paid on the contract. DAC on term insurance contracts is generally amortized in proportion to premiums. A participating contract generally pays dividends, and its DAC is amortized in proportion to gross margins. Paragraph 15e provides that in order for an exchange to be considered substantially unchanged “there is no change in the participation or dividend features of the contract, if any.” Paragraph 15f provides that in order for an exchange to be considered substantially unchanged “there is no change to the amortization or revenue classification of the contract.” To the extent a term to par whole life exchange fails both of these provisions, such an exchange would generally be considered a substantially changed internal replacement. Such a transaction may also fail paragraph 15b, to the extent there are significantly different investment return rights between a term and whole life policy.

Q47: How does the SOP apply to modifications from term to non-par WL?

A47: Both term and non-par whole life contracts are accounted for under FAS 60. Therefore, paragraphs 15e and 15f would generally not cause such an exchange to be treated as substantially changed. However, term insurance typically does not have cash values, while non-par whole life does have a cash value that includes minimum guarantees on accumulation. Therefore, the actuary should consider whether such an exchange is a substantially changed internal replacement, according to paragraph 15b. Paragraph 15b requires that in order for an exchange to be substantially unchanged “the nature of the investment return rights, if any, has not changed between the insurance enterprise and the contract holder.”

Q48: How does the SOP apply to the addition of an extended maturity rider to a policy?

A48: Adding an extended maturity rider generally causes the period for which a contract is subject to mortality risk to lengthen. For example, the original contract may have endowed at age 95, while after adding the rider the endowment age is 110. Thus, the insurance company is subject to an additional 15 years of mortality risk for the contract. Paragraph 15a requires that for an exchange to be considered substantially unchanged “the insured event, risk, period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality, morbidity or other insurance risk, if any.” When an extended maturity rider is added to a policy, it is likely the “period of coverage” has changed. However, whether the change is “significant” is subject to interpretation. Paragraph A.27 provides further guidance. In particular, “AcSEC noted that, in determining whether a change in the degree or kind of risks in a contract is significant, the focus should be on the substance of the risks of the contract, and not on the form of the contract. Factors to consider in determining whether there are significant changes in insurance risk may include changes in actuarially determined estimated costs for that benefit or the SOP 03-1 benefit ratio related to that benefit feature.” Thus, if the

actuarial present value of the expected mortality costs during the extended coverage period is small, the addition of an extended maturity rider may be considered a substantially unchanged internal replacement. However, there are other methods an actuary could use to make this determination that could result in a different determination.

The actuary should review TPA 6300.33 which states, "A change in the period of coverage should be evaluated based on a comparison of the remaining period of coverage of the replaced contract to the remaining period of coverage of the replacement contract when assessing the significance of that change."

Q49: How does the SOP apply to increasing death benefit coverage on a traditional life contract?

A49: Paragraphs B.2 through B.6 describe three methods of increasing death benefit coverage on a traditional life contract.

- A contract may include an option to purchase additional insurance (OPA) rider. This gives the contract holder the right to purchase additional insurance coverage with no additional underwriting. The additional premium is commensurate with the additional insurance coverage obtained. In determining the treatment of these options under the SOP, the actuary should consider paragraph B.3, which states that exercise of the option to purchase additional coverage under the OPA rider is "an example of a nonintegrated contract feature. Once purchased, the benefit under the OPA rider generally is accounted for as a separate contract."
- A contract holder may obtain a second life insurance policy for an incremental face amount, with underwriting on the new policy only and no change to the original contract. In determining the treatment of these options under the SOP, the actuary should consider paragraph B.5 which states, "this transaction does not fall within the definition of an internal replacement in paragraph 8 of this SOP. The accounting for the original contract remains unchanged and the new contract is accounted for independently of the original contract. Any deferrable acquisition costs associated with the new contract are deferred and amortized according to the revenue or margin stream of the new contract, as applicable."
- The original contract could be modified by amendment or rider to increase the face amount. In determining the treatment of these options under the SOP, the actuary should consider paragraph B.6 which states, this "is considered a nonintegrated benefit feature that should be accounted for separately from the existing life insurance contract, provided that the additional premium...is not in excess of an amount commensurate with the incremental insurance coverage and does not result in the explicit or implicit reunderwriting or repricing of other components of the contract."

Q50: How does the SOP apply to elections of nonforfeiture benefits?

A50: Elections by whole life policyholders to exercise nonforfeiture benefits, such as reduced paid up insurance or extended term insurance, would generally not be considered internal replacements. Paragraph 10 states that “reductions in coverage, as allowed by terms that are fixed and specified at contract inception either in the contract or other information available to the contract holder...are not internal replacements subject to this guidance, as long as there are no reunderwriting or other modifications to the contract, at that time...” However, if the nonforfeiture benefit involves some modification other than a reduction of face amount or term of insurance, such as a change to participation features or dividend rights, the nonforfeiture benefit may need to be evaluated to determine whether it is an internal replacement subject to the provisions.

Q51: How does the SOP apply to a reinstatement of a policy?

A51: The actuary should consider TPA 6300.29, which suggests that when there is a legal termination of the original contract, and the associated DAC has been extinguished, the reinstatement of the contract would be accounted for as a newly issued contract in the period in which the reinstatement occurs. Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets related to the terminated contract ordinarily would not be reestablished in connection with the newly issued contract.

UL/VUL Business

Q52: How does the SOP apply to an increase in face amount?

A52: Paragraph B.8 concludes that a face amount increase on a universal life-type contract through an amendment to the original contract is considered an integrated feature because “only the additional face amount has been underwritten during the contract amendment” and “the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained.” Thus a universal life face amount increase of this type would generally not constitute a substantial change, and DAC would be continued. If, however, there were underwriting of the face amount of the original contract during the contract amendment, or if the charge for the increased face amount was in excess of an amount commensurate with the increased death benefit, this would be a substantially changed internal replacement, and DAC would be written off. Paragraph B.8 only considers face amount increases on Option A death benefit plans. Some actuaries believe that face amount increases to Option B contracts are nonintegrated because it is akin to adding a term rider to the base contract (which some believe is a nonintegrated benefit feature) and, thus, should be accounted for separately.

A reduction in face amount would likely be considered a “reduction in coverage” under paragraph 10. Thus, they would not be considered internal replacements under the SOP, so long as the modification was “allowed by terms that were fixed and specified at contract inception...”

Q53: How does the SOP apply to the modification of a universal life policy to a universal life policy with a no-lapse guarantee?

A53: Paragraph B.9 describes a situation where a universal life contract without a no-lapse guarantee is exchanged for a universal life contract with a no-lapse guarantee, or where a no-lapse guarantee is added to a universal life contract by rider. Paragraph B.9 describes this exchange as a substantially changed internal replacement because “the addition of the no-lapse guarantee changes both the period of coverage of the contract as well as introducing a combination of mortality and investment risk.”

Some actuaries believe that adding a relatively insignificant no-lapse guarantee (such as a short no-lapse period on a variable universal contract) would not constitute a substantial change because the period of coverage would not be significantly altered and because the combination of investment and mortality risk introduced by such a feature is minimal. Those holding this view believe companies would likely need to perform some analysis under paragraph 15a and base their conclusion as to whether there has been a significant change to the insured event on the specific facts and circumstances.

Q54: How does the SOP apply to the modification of a universal life policy to a universal life policy with second-to-die feature?

A54: Paragraph B.10 describes a situation where a universal life contract is exchanged for a universal life contract with a second-to-die feature (such as a joint-and-last-survivor contract). Paragraph B.10 describes this exchange as one that renders a contract substantially changed because “the addition of the second-to-die feature changes the insured event, as now two mortality events must occur for the beneficiary to receive the proceeds.”

Annuity Business

Q55: How would a variable annuity with a guaranteed minimum accumulation or withdrawal benefit (defined in the original contract) that includes a policyholder-elected step-up benefit be treated under the SOP at the time the policyholder elects a reset?

A55: Some actuaries believe that for such a contract, an elected reset that does not involve any additional fee and that was accounted for from contract inception would not be an internal replacement because the requirements of paragraph 9 would be satisfied.

However, other actuaries believe that if the fee charged to the policyholder changes on reset, the election would be considered an internal replacement because paragraph 9c states that the contract is exempted only if the insurance enterprise cannot “adjust the pricing of the benefit, feature, right, or coverage.” Under this interpretation, which typically have been determined to be integrated since the guaranteed minimum benefits are a function of the base contract's account value, the requirements of paragraph 9 will

not be met and the change will need to be evaluated under paragraph 15. Some of the actuaries who interpret paragraph 9 this way believe that the feature satisfies the conditions of paragraph 15b because the nature of the investment return rights has not changed. Others believe that one needs to examine the significance of the change to determine if the condition in paragraph 15b is satisfied. In addition, it may be prudent to consider the provisions of paragraph 15c regarding additional charges.

Q56: How does the SOP apply to the modification of a variable annuity contract to a fixed annuity contract?

A56: Paragraph B.31 describes a situation where a fixed-rate GIC is exchanged for a variable-rate GIC. This is described as a significantly changed internal replacement because “the investment return rights...are different between the two contracts.” The actuary may need to consider whether the treatment would be similar when a fixed annuity is replaced by a variable annuity or vice versa. This would appear to fail the conditions of paragraph 15b as the investment return rights have changed from “pass through” to “at the discretion of the insurance company,” (regardless of whether or not the variable annuity that is part of the exchange includes a fixed rate option) because the ability to move the account balance into variable funds in itself may represent a significant change to the investment rights.

Q57: How does the SOP apply to the modification of a single premium deferred annuity contract to a market value adjusted annuity contract?

A57: Paragraphs B.23 through B.25 describe a situation where a single premium deferred annuity (SPDA) is exchanged for a market value adjusted (MVA) annuity. This is described as a substantially unchanged internal replacement because “the only significant substantive difference between the two contracts is the manner in which amounts are determined in the event of a premature surrender.” The MVA feature in this example is effectively a change to the surrender charge characteristics of the contract, and changes to surrender charges by themselves do not contradict any of the criteria for a substantial change in paragraph 15 as explained in paragraph B.25, and elaborated in Q/A41 in this document. Therefore, this would not be a substantial change. If, in addition to adding an MVA feature, a change is made to the interest guarantee that could apply to a significant part of the remaining contract life, the modification would need to be evaluated under paragraph 15, and the company could interpret it as a change from discretionary to formulaic interest crediting, thus failing paragraph 15b. Actuaries are ordinarily prudent to refer to paragraph A.30 in these situations.

Q58: How does the SOP apply to the modification of a single premium deferred annuity contract to an equity-indexed annuity contract?

A58: Paragraphs B.26 and B.27 describe a situation where an SPDA is exchanged for an equity indexed annuity (EIA). This is described as a substantially changed internal replacement because “the nature of the contract holder’s investment return rights differs significantly between the two contracts. The crediting rate of the SPDA contract is

declared at the discretion of the insurance enterprise, while the crediting rate of the EIA is contractually determined by reference to a pool of assets, an index or other specified formula.”

Q59: How does the SOP apply to the modification of a single premium deferred annuity contract to a multi-bucket annuity contract?

A59: Paragraphs B.28 and B.29 describe a situation where an SPDA is exchanged for a multi-bucket annuity. This is described as a substantially changed internal replacement because “the nature of the investment return rights are different between the two contracts.”

Q60: How does the SOP apply to the deletion of GMIB/GMAB/GMWB benefit from a variable annuity contract?

A60: Paragraphs B.39 through B.42 indicate that in a situation where a GMIB, GMAB or GMWB is added to a variable annuity that did not previously have one or provide for adding one in the future subject to the conditions of paragraph 9, this would generally constitute a substantially changed internal replacement. This is because the addition of these benefits changes the investment return rights of the contract holder by adding a minimum investment return provision. Under paragraph 15b this produces a substantial change.

The SOP does not provide examples of removing one of these benefits from a variable annuity contract. Some actuaries believe that removing one of these riders would also constitute a substantially changed internal replacement. That is because they believe removing a GMIB, GMAB or GMWB also changes the investment return rights of the contract holder. And this would be a substantially changed internal replacement.

Other actuaries believe that removing a GMIB, GMAB or GMWB rider is not a change of investment rights, but a reduction in coverage, if the right to remove the benefit was specified in the original contract. Paragraph 10 provides that reductions in coverage as allowed by terms that are fixed and specified at contract inception are not internal replacements subject to the guidance.

Q61: How does the SOP apply to the modification of a return of premium GMDB to ratchet or rollup GMDB?

A61: Paragraph A.27 notes that “an example of a significant change in the degree of mortality risk would be an internal replacement of a variable annuity with a minimal death benefit to a variable annuity with a ‘rich’ death benefit...” It goes on to state that, “AcSEC concluded that an exchange of a contract with one type of death benefit for a contract with another type of death benefit requires review of the terms to determine whether the degree of mortality is similar.”

Paragraphs B.32 and B.33 provide an example of a return of premium GMDB for a ratchet GMDB. The paragraphs note that “in this instance, the preparer analyzed and concluded that a significant change in the SOP 03-1 benefit ratio, as well as the actuarially determined expected mortality costs, were indicative of a substantial change in the degree of mortality risk.” They also note “other methods and approaches could have been used to evaluate the change in mortality risk.”

Other actuaries believe that the example in the SOP is inconclusive, and may not apply to all situations. These actuaries also look to the example of a face increase on a UL contract as described in paragraph B.8. Paragraph B.8 concludes that a face increase on a universal life-type contract is not a substantial change if there is no underwriting other than for the additional face amount and if “the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained.” Because variable annuities with GMDBs are generally classified as “universal life-type contracts”, these actuaries believe that in determining whether a ratchet GMDB to a ratchet rollup GMDB is a substantial change they must also look at whether the increased charge for the richer death benefit is commensurate with the increased benefit. If the charge is in excess of an amount commensurate with the increased benefit, these actuaries believe there is a substantial change in the degree of mortality risk. Otherwise, they believe that there is no change to the degree of mortality risk.

These actuaries do believe that if the death benefit under the return of premium GMDB was insignificant enough that the contract was accounted for as an investment contract, then the addition of a richer benefit, whose addition requires classification as a universal life-type contract, would constitute a substantial change to the contract (both a change in the mortality risk under paragraph 15a and a change in the amortization method under paragraph 15f).

Some actuaries believe that the replacement of a richer GMDB (such as ratchet or rollup) by a return of premium GMDB would constitute a reduction in coverage. Thus, under paragraph 10 these modifications would not constitute internal replacements subject to the guidance, so long as the modification was “allowed by terms that were fixed and specified at contract inception...”

Individual Health Business

Q62: How does the SOP apply to the replacement of an individual health insurance policy with a newly upgraded policy?

From time to time, companies may update individual health insurance policies to reflect changing health care practices, including technologies and procedures which may not have been in existence when the original policy was written. Does such a policy exchange constitute an internal replacement and, if so, is the new contract substantially changed from the old contract?

A62: As with many questions, it is impossible to answer this one without reference to the facts and circumstances associated with the transaction. However, in assessing the situation, the actuary may find the following considerations relevant:

- Is the change in features achieved through the issuance of a new contract? Though the SOP appears to make it clear (paragraph A.4) that the technical structure of a contract modification is not relevant *per se* to a conclusion as to the classification of a contract modification, such structure (e.g., where the modification was accomplished through the issuance of a new contract) could provide an indication of the nature of the modification (e.g., the fact that a new contract was issued rather than a rider added to an existing contract may indicate that the newly added feature is integrated with the existing contract). However, the issuance of a new contract does not automatically imply a substantially changed contract.
- Was the change accompanied by a change in premium? Without a change in premium, the change may be an indication that the insured risks have not materially changed, meaning that the contract is substantially unchanged.
- Was the change contemplated under the original terms of the contract? If so, then the modification may not be a contract replacement, provided that the change is within a narrow range allowed within the contract.
- Does the contract provide additional benefits for an added fee while leaving existing benefits unchanged? In such a case, the additional benefits and any associated premium may be interpreted to be a new contract (and accounted for as such) with the existing benefits and original premiums not considered to be an internal replacement.

Group Business

Q63: How does the SOP apply to adding a new member to a group insurance policy?

A63: Some actuaries believe that adding a new member to a group insurance policy would likely not be considered an internal replacement subject to the guidance. An example within the SOP would be the addition of a new car to an automobile policy. Under paragraph B.11, the new car would generally be considered a nonintegrated coverage, and accounted for separately from any previously covered cars.