



AMERICAN ACADEMY *of* ACTUARIES

Practice Note on Anticipated Common Practices Relating to AICPA Statement of Position 03-1: Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts

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The Academy welcomes your comments and suggestions for additional questions to be addressed by this practice note. Please address all communications to Steve English, Senior Life Policy Analyst at (english@actuary.org).

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Introduction

This practice note was prepared by a work group organized by the Life Financial Reporting Committee of the American Academy of Actuaries. The work group was charged with developing a description of some of the anticipated common practices that might be considered by actuaries in the United States.

The practice note represents a description of practices believed by the work group to potentially be employed by actuaries in the United States in 2004. Statement of Position (SOP) 03-1 is effective generally starting 2004 and potential practices presented here were contributed by actuaries in industry, consulting and public accounting firms involved in implementation of the SOP. The purpose of the practice note is to assist actuaries with implementation 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. Other practices will undoubtedly come into use as the SOP is implemented.

This practice note has been divided into six sections:

- Section A: General GAAP requirements for life and annuity contracts
- Section B: GAAP liabilities for minimum death benefit and other insurance guarantees
- Section C: GAAP liabilities for minimum annuitization guarantees
- Section D: GAAP liabilities and assets for sales inducements
- Section E: Reinsurance Issues
- Section F: Transitional rules

*Please note that the FASB Issues Paper (referred to in Q1 of this document) was a draft only and, in fact, was not released. Instead, as of this time, FASB is contemplating preparing a FASB Staff Position (FSP) on this topic, which they hope to have out soon for a 30-day comment period.

Section A: General GAAP Requirements for Life and Annuity Contracts

Q1. What is the scope of the SOP and how does it relate to existing GAAP requirements?

A1. Paragraph 9 of the SOP sets out the scope and states “*This SOP is applicable to all entities to which FASB Statement No. 60, as amended, applies, hereinafter referred to as insurance enterprises.*” While the scope sets out which entities are covered (essentially all insurers), it does not address which of their products are covered. The interpretations of which products are covered include the following:

1. The title of the SOP is “*Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts.*” Also, the Introduction and Background sections mention products with nontraditional terms or benefits where FAS 60 or FAS 97 did not address the accounting. Some actuaries believe then that the SOP covers only FAS 97-type products (universal life-type or annuities) and separate accounts. Although FAS 120 (participating products) is not specifically mentioned, FAS 120 is an amendment to FAS 60 and FAS 97, and FAS 120 products would thus appear to be covered to the same extent. Also, the FASB Issues Paper referenced below states in its background section that SOP 03-1 applies to FAS 120.
2. Other actuaries believe, title notwithstanding, that the scope covers all insurers and by implication all their products as appropriate (note that the scope section does not limit the application of the SOP to any class of products). For example, annuitization option considerations as set out in the SOP would then be equally applicable to traditional products’ settlement options.

SAS 69 gives the hierarchy of various financial pronouncements: AICPA Statements of Position are considered Category (b) which rank below Category (a) pronouncements which include FASB Statements of Financial Accounting Standards. An SOP thus can add to but cannot overrule an FAS.

Note that as of date of release of this Practice Note, FASB has exposed for comment an Issues Paper that has relevance to the SOP and which is titled “Accounting for Unearned Revenue Liabilities related to a FASB Statement No. 97 Universal Life-Type Contract with Death or Other Insurance Benefit Features.”

Q2. What role do actuaries play in interpreting the provisions of the SOP?

A2. Actuaries are qualified to provide guidance in interpreting the SOP. However, the final interpretation will result from the accounting profession’s rule setting process.

Q3. What are the key items of interest to actuaries covered by SOP 03-1?

A3. Following are the key items of interest to actuaries covered by the SOP:

1. Paragraph 11 of the SOP sets out four conditions for recording a separate account arrangement at fair value, including the requirement that all investment performance, net of contract fees, be passed through to the contract holder. If the four conditions are not all met, the separate account's assets and liabilities are accounted for as general account assets and liabilities.
2. Under FAS97, the base benefit liability is the contract holder account balance. There are situations where a contract has multiple account balances defined; the SOP clarifies that the account balance to be reported as a liability in the company's financial statements is that which is essentially available in cash. For example, paragraph D5 of the SOP requires that the lower cash value tier versus the annuitization tier apply for a two-tier product. The SOP, in paragraphs 20 through 23, further clarifies that the base liability is the account balance prior to any surrender charges or market value adjustments. Finally, it requires that accrued but not yet credited benefits be included in the liability.
3. Guidance is given in determining the significance of mortality and morbidity risk to be used in the classification of a contract as an investment contract or a universal life-type contract as defined in FAS 97. The determination is made at contract inception (exceptions apply at initial implementation of the SOP and for the reinsuring company upon initial reinsurance of inforce contracts). The general criteria are based on the present value of benefits in excess of the account value as compared to the present value of amounts assessed against the contract. Contracts where the amount of insurance varies significantly in response to the capital markets are presumed, unless rebutted, to have significant insurance risk. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility.
4. Liabilities in addition to the account balance might be required for certain insurance benefit features for universal life-type contracts as defined in FAS 97. Specific examples given are minimum guaranteed death benefits (MGDB) on variable products and no-lapse guarantees on universal life-type contracts. A methodology is prescribed for calculating these liabilities.
5. Liabilities in addition to the account balance might be required for annuitization options typically offered under life insurance and deferred annuity contracts. Specific examples given are guaranteed minimum income benefits (GMIB) on variable products and the higher account balance available upon annuitization for two-tier annuities. A methodology is prescribed for calculating these liabilities.

6. Sales inducements are defined. The SOP requires a liability to be accrued over the period in which the contract remains in force for the contract holder to qualify for the inducement or at the crediting date, if earlier. Examples given are a bonus at issue (an additional liability is not necessary if the bonus is actually credited to the account balance), a persistency bonus, and an enhanced crediting rate (“bonus interest”) over an initial contract period. Additionally, certain sales inducements qualify for deferral as an asset in the same way as, but separate from, deferred acquisition costs (DAC). Deferred sales inducement costs are to be amortized over estimated gross profits (EGPs) over the life of the contract. Sales inducements that were not capitalized previously are not capitalized at transition.

Q4. What other items are covered by SOP 03-1?

A4. Following are additional items covered by the SOP:

1. GAAP separate account treatment applies only to contract holder funds of variable products that meet four specific criteria (accounts are legally recognized, the assets are legally insulated from general account liabilities, contract holder directs investment strategy and all investment performance, net of contract fees and assessments, must go to the contract holder). An insurer might have an ownership interest in the separate account (“seed money”); the insurer may record its ownership as a mutual fund-type investment provided it has less than 20% of the total separate account, otherwise it must apply a look-through to the underlying assets (i.e., use general account treatment). Rules are defined for recording gains/losses on transfers of assets between the general account and separate account. Finally, certain variable-like accounts where the insurer owns the assets (total return contracts) are required by the SOP to record liabilities at fair value whether or not the assets are at fair value.
2. A variety of disclosures are now required with the financials covering separate accounts, insurance guarantees, annuitization guarantees, and sales inducements. Required disclosures include methodology descriptions and net amount at risk (NAR) exposures.
3. Transition rules are given for various requirements. Additional liabilities and changes in DAC or present value of future profits for acquired business (PVP) resulting from changes to estimated gross profits (EGPs) are required by the SOP to be accounted for as a change in accounting principle.

Q5. Are benefits valued under FAS 133 within the scope of the SOP?

A5. Benefits valued under FAS 133 appear to be outside the scope of the SOP. Paragraph 7 of the SOP states. *“Embedded derivatives contained in nontraditional contracts should be accounted for in accordance with FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and its related guidance.”* The SOP clarifies in several places, for example, paragraphs 21 and 31, that it does not apply to contract features falling under FAS 133.

However, contracts containing embedded derivatives might have other benefit features that are outside the scope of FAS 133 and it appears these features would then fall under the SOP. Also, FAS 133 allowed companies a choice to exempt contracts that were in force prior to its adoption, and it would appear these grandfathered contracts then fall under the SOP.

Section B: GAAP Liabilities for Contracts with Death or Other Insurance Benefit Features

Q6. What are the circumstances under which the SOP might require liabilities in addition to account balances for insurance benefits?

A6. Additional liabilities for insurance benefits might be required when all of the following apply:

1. A contract contains a mortality or morbidity contingent benefit feature providing for payment of an amount in excess of the account balance;
2. The contract is classified as a FAS 97 universal life-type contract with fees and benefits that are not fixed and guaranteed; and
3. It is expected that periodic charges assessed for insurance benefits will result in profits in early years and losses in subsequent years (i.e., there is an element of front-ending of charges relative to benefits incurred).

The SOP requires a determination to be made as to whether the insurance risk in a contract meets the test of being significant. If not, the SOP requires the contract to be classified as an investment contract with no additional liabilities held for the insurance benefits (insurance benefits, if any, thereby deemed by the SOP to be non-significant). This determination is usually made at inception of the contract and would not usually be subsequently reconsidered (exceptions apply at initial implementation of the SOP, and for the reinsuring company upon initial reinsurance of in force contracts).

Q7. What are examples of benefit features that might require additional insurance liabilities?

A7. The SOP specifically mentions the following:

1. Minimum guaranteed death benefits (MGDB) provided under variable annuity contracts (paragraph 3);

2. No-lapse guarantees that keep universal life (UL) and variable universal life (VUL) contracts in force when the account balance is zero and any minimum stipulated premiums are insufficient to cover the cost of insurance plus all other contract charges (paragraph 3);
3. Long-term care or similar insurance benefits provided during the accumulation phase of a deferred annuity (paragraph D21);
4. Earnings protection benefits on deferred annuities that pay a death benefit in excess of account balance to cover taxes on contract earnings (paragraph D22); and
5. MGDB or other insurance benefits provided with mutual fund or other noninsurance contracts (paragraph 30).

The above are examples only; any benefit paid in excess of the account balance and based on mortality or morbidity contingency would generally be considered. These insurance benefit features would usually be considered both by the insurer providing the benefit directly and by a reinsurer assuming all or a portion of the risk.

Q8. What would generally be considered in deciding to classify a deferred annuity as an insurance contract versus an investment contract?

A8. Paragraph 24 of the SOP states, *“If the **mortality** and **morbidity** risk associated with insurance benefit features offered in a contract is deemed to be nominal, that is, a risk of insignificant amount or remote probability, the contract should be classified as an investment contract; otherwise, it should be considered an insurance contract.”* So, if a deferred annuity provides for the possibility that death or morbidity benefits will be paid in excess of the account balance, the actuary would usually assess the significance of the insurance risk. (Determination of materiality regarding what is “significant” is outside the scope of this Practice Note. However, paragraph 24 of the SOP does provide some guidance with references to terms such as “nominal”, “insignificant” and “remote.”) If it is determined that the amount of benefits expected to be paid for the contract is insignificant or there is only a remote probability that benefits in excess of the account balance will be paid, the contract is classified as an investment contract, otherwise, the contract is classified as an insurance contract.

Paragraph 24 of the SOP provides a rebuttable presumption that insurance risk is significant if insurance benefits *“would vary significantly in response to capital markets volatility.”* Thus, for example, variable annuities with MGDB would usually be classified as universal life-type insurance contracts unless the actuary has a persuasive case to rebut the presumption that the insurance risk is significant.

According to paragraph 25 of the SOP, in determining whether the insurance risk is significant, the actuary generally projects expected insurance benefits and contract revenues under a *“full range of scenarios, that considers the volatility inherent in the assumptions, rather than making a best estimate using one set of assumptions.”*

Insurance benefits include amounts paid in excess of the account balance and related claim administration costs. Contract revenues include amounts assessed against the contract holder, including investment margins, surrender charges and policy fees. The present value of expected benefits is compared to the present value of expected assessments (revenues) across the range of scenarios tested.

For example, if benefits in excess of account balance are projected in virtually all scenarios but the present value of these benefits is almost always relatively small compared to the present value of assessments, the actuary might conclude the insurance risk is insignificant and classify the contract as an investment contract. On the other hand, if the present value of these benefits is relatively large in even a few scenarios, the actuary might conclude the insurance risk is significant and classify the contract as an insurance contract.

Q9. If the insurance risk is significant, does the SOP always require that insurance liabilities be held in addition to the account balance?

A9. Paragraph 26 of the SOP states that an additional insurance liability should be established *“if the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function.”* Some actuaries interpret this to mean additional insurance liabilities should be considered only if insurance charges are expected to be more than insurance benefits in early years and less than insurance benefits in later years. This is termed the “profits followed by losses” test. Q14 discusses the situation of “larger profits followed by smaller profits,” and Q18 the situation of “smaller losses followed by larger losses.” See Q16 for a discussion of what might be considered in determining insurance charges.

Q10. Does the actuary usually consider a range of scenarios to determine whether to expect profits followed by losses from the insurance benefit feature?

A10. As discussed in Q9 above, paragraph 26 of the SOP requires an assessment as to whether profits followed by losses is expected. Paragraph 26 goes on to say, *“expected experience should be based on a range of scenarios rather than a single set of best estimate assumptions.”* As discussed in Q8 above, a full range of scenarios is also usually considered in determining whether the insurance risk is significant.

In this light, some actuaries believe it is likewise appropriate to consider a range of scenarios to determine whether to expect profits followed by losses from the insurance benefit feature. Other actuaries, however, may believe it is appropriate in some or all situations to look at a single deterministic scenario based on the best estimate assumptions used in DAC amortization.

Q11. Does the SOP require the test for “profits followed by losses” to be performed for each benefit feature on a standalone basis, or may one aggregate at the entire contract level or some other level?

A11. Paragraph 26 of the SOP states the test for profits followed by losses in terms of “*the insurance benefit function.*” Some actuaries interpret this to require each benefit feature to be tested on a standalone basis. Also, they might note that some benefit features might fall under FAS 133 and would be exempt from the SOP, whereas other benefit features of the same contract might need to be tested (see Q5 above). Notwithstanding this, it might be reasonable for practicality reasons to aggregate certain related benefit features.

Other actuaries believe it is preferable to consider the contract in whole for the test. They might believe that a nominal allocation of total charges among the various benefit features would not necessarily reflect the true economics of, for example, benefits that have no explicit charge or that are effectively subsidized by charges elsewhere (see Q16 below).

Q12. My company issues a typical UL product. What would we usually consider to determine if additional liabilities are required under the SOP?

A12. As discussed in Q9 above, paragraph 26 of the SOP requires an insurance liability in addition to the account balance for a benefit feature with an expectation of profits followed by losses. Some actuaries might believe this applies only to no-lapse guarantees and other nontraditional benefit features, while other actuaries might believe it applies much more generally. These two views might lead to very different accounting results for a UL or VUL product in which cost of insurance charges (COIs) do not closely follow the pattern of expected death benefit costs. This could include products with reverse select and ultimate COI scales, level COI scales or even attained age aggregate COI scales.

The two different views described above might be summarized as follows:

1. Those who believe the SOP applies only to no-lapse guarantees and other benefit features not contemplated when FAS 97 was issued might believe it could be presumed that FAS 97 addressed adequately the known benefits at that time, and might point out that a statement of position cannot overrule a financial accounting standard (see Q1 above). They might believe practice is well established for handling variations in the pattern of COI scales versus the underlying expected mortality. Depending on the degree of mismatch together with consideration of the overall pattern of estimated gross profits, one would usually make a determination on whether to establish an unearned revenue liability (URL) under FAS97 to handle significant front-ending of COIs.

2. Those who believe the SOP applies more generally, however, might believe an additional reserve is required whenever profits followed by losses are expected whether from traditional or nontraditional benefit features within UL and VUL contracts. Those taking this view might believe the SOP was intended to clarify how FAS 97 should be applied in situations where insurance charges have any element of front-ending in order to have more consistent industry practice.

Q13. My company issues a UL contract with level COIs. COIs are less than expected death benefit expenses at the later durations. We currently defer a portion of early year COI charges as unearned revenue. Does the SOP require us to do anything different?

A13. The answer to this question depends not only on the specific circumstances of the UL contract, but might also depend on the actuary's view of the scope of the SOP as discussed in Q12. For example:

1. Those who believe the SOP applies only to nontraditional benefit features might conclude that the unearned revenue liability (URL) currently held is all that is usually required under GAAP.
2. Those who believe paragraph 26 applies more generally might conclude for this example either: (a) it is usually appropriate to hold an additional insurance liability instead of the URL; or (b) it is usually appropriate to hold the URL and test for whether an additional insurance liability is needed by considering charges on an incurred basis (i.e., COIs net of changes in URL).

Q14. My company issues a UL contract with reverse select and ultimate COI charges. Although the margin of COI charges over expected death benefits decreases over time, it is always positive. We currently defer a portion of COI charges as unearned revenue. Does the SOP require us to do anything different?

A14. As noted in Q1, FASB has exposed an Issues Paper, "Accounting for Unearned Revenue Liabilities related to a FASB Statement No. 97 Universal Life-Type Contract with Death or Other Insurance Benefit Features." The Issues Paper sets out two views, one of which will likely be decided upon by FASB as being ruling, as follows:

1. View A would essentially require in the case of a reverse select and ultimate UL that any URL held be set to zero as part of the SOP implementation. The argument presented is that FAS 97, as interpreted by the SOP, requires profits followed by losses as a necessary condition for deferral of a portion of COI charges. It does not permit a "smoothing" of higher profits followed by lower profits.
2. View B would essentially permit deferral of a portion of COI charges for a reverse select and ultimate UL if this is supported by evidence that portions of the early duration COIs represent loads designed to provide for subsequent contract services.

The argument presented is that the profits followed by losses test is just one consideration discussed in paragraph 61 of FAS 97, and that the FASB acknowledged in that paragraph that other facts and circumstances might lead to a conclusion that a portion of COI charges should be deferred.

Based on the outcome of the Issues Paper, the actuary would usually either set to zero or maintain the URL currently being held. In either case, additional insurance liabilities typically would not be held for the reverse select and ultimate UL example above, as it does not satisfy the SOP profits followed by losses test.

Q15. I have a UL contract with a no-lapse guarantee feature. How does the SOP apply to this feature?

A15. For a no-lapse guarantee UL, the contract is guaranteed to stay in force provided minimum premiums are paid (minimum premiums either as stipulated in the contract, or implicit as required to maintain a positive balance for a secondary “shadow” account). So, the contract stays in force even where the account balance goes to zero and the minimum premiums are insufficient to cover the COIs plus all other contract charges such as expense loads and policy fees. At least two approaches are possible to determine whether or not an additional insurance liability is needed for a contract with this benefit feature.

As discussed in Q11 above, some actuaries might believe it is appropriate to consider the entire contract as subject to the SOP. The test for profits followed by losses typically would then be considered for the entire contract, and losses might be expected in the event the no-lapse guarantee is activated.

Other actuaries might believe it is appropriate to consider the no-lapse guarantee as a standalone benefit feature. In doing a standalone test, as well as in calculating liabilities when applicable, the actuary would usually determine what constitutes the “benefit.” The alternatives might include the following:

1. Some might consider the benefit to be a waiver of the amount of scheduled charges in excess of minimum premiums once the account balance has gone to zero. Some might believe it is usually appropriate to limit this benefit to the amount of scheduled COIs, as waiver of a portion of the expense loads might be considered a non-insurance benefit.
2. Others might consider the benefit to be death benefits paid on contracts maintained in force by the no-lapse guarantee. Some might believe it is usually appropriate to include all death benefits whether or not the contract is currently able to cover its COIs, while others may believe it is usually inappropriate to include death benefits unless paid in a period when charges are waived by the no-lapse guarantee.

Since charges for no-lapse guarantees are often implicit only, the actuary might also determine what to use for insurance charges in testing for profits followed by losses. This is discussed further in Q16.

Q16. In testing for profits followed by losses from an insurance benefit feature, what would I use for “amounts assessed” against contract holders?

A16. Paragraph 26 of the SOP refers to “*amounts assessed against the contract holder each period for the insurance benefit feature.*” Actuaries might have various interpretations of this phrase, including the following:

1. Some might believe one would usually only use insurance charges stated explicitly in the contract for each benefit feature, for example, COIs for a UL benefit or basis points of account balance charges for a VA benefit rider. In situations where insurance charges are not explicit, zero charges would usually be assumed; this would generally result in only losses expected (Q18 discusses the situation where only losses expected).
2. Others might believe one would usually use explicit charges when these exist, and imply charges when explicit charges do not exist. Judgment might be needed in determining the implied charges. In some cases, insurance benefits might be implicitly funded in full or in part out of interest or other margins. Paragraph A34 of the SOP recognizes this, as it says: “*Due to multiple designs, some of which may include no explicit fee for the insurance benefit feature, AcSEC concluded that the liability in addition to the account balance should be based on total assessments, including investment spread, to eliminate design features receiving different accounting treatment.*”
3. Yet others might believe it is appropriate to aggregate all the assessments of a contract and then allocate this total among the various benefit features. Specifically, this could be done consistent with the methodology used in determining the benefit ratio (BR), i.e., based on the ratio of present value of expected benefits and related expenses for that feature to present value of total expected assessments, over a full range of scenarios. Again, support for this approach comes from paragraph A34 of the SOP, as quoted above. Although this statement in paragraph A34 is made in the context of determining the additional insurance liability, some believe the same goal of avoiding different accounting treatment for similar design features should also apply to the test for profits followed by losses. They may believe dividing total assessments among the benefit features would better ensure consistent treatment. An issue is whether or not to gross up for profit (see discussion in Q17 below).

Q17. In testing for profits followed by losses, would I generally make an allowance for profit margin when determining implicit charges for a benefit feature?

A17. The significance of this question is that including a profit margin could possibly change a projected loss to a profit. Some actuaries believe charges gross of profit are appropriate as this is how explicit charges are typically determined. They might object to using the SOP to smooth out profits, i.e., where there are bigger profits followed by smaller profits. They might also believe the use of net assessments could result in too broad an impact (note that on a net basis, one dollar of profit now means one dollar of future loss since overall results must net to zero).

Other actuaries might believe that the use of net assessments is appropriate. Those taking this interpretation might posit that the SOP was intended to clarify how FAS 97 should be applied in situations where insurance charges have any element of front-ending in order to have more consistent industry practice.

Of course, as discussed in Q16, some actuaries may believe it is appropriate to consider only explicit insurance charges in testing for profits followed by losses and not to imply charges when there are no explicit charges.

Q18. Might I consider an additional insurance liability if I expect smaller losses followed by larger losses?

A18. Some actuaries might believe there is an element of front-ending of assessments that is indicated by that pattern of earnings and, in the spirit of the SOP, an additional insurance liability would therefore be considered. For example, this might be appropriate when there is no rider fee or when the explicit rider fee charged for some benefit is in reality being subsidized by other contract charges.

Other actuaries might believe no additional insurance liability is needed, as this does not meet the SOP test of profits followed by losses. However, depending on the extent to which other contract assessments are available to cover losses, the level at which the company performs premium deficiency testing and the materiality of that block, expected losses on the block might possibly make it appropriate to consider reserve strengthening.

Q19. If I have a single premium life contract with no explicit COI charges, how do I apply the SOP?

A19. If the actuary believes the SOP applies to this type of contract (per the second view discussed in Q12 above), the actuary would usually consider the various approaches discussed in Q16 to determine amounts assessed for the insurance benefit feature in this contract. The actuary might also want to consider the discussion in Q18 of situations where only losses are expected.

Q20. In testing for expected profits followed by subsequent losses, how far in the future is “subsequent?” I have a UL with a 5-year no-lapse guarantee. Does the SOP apply?

A20. The SOP does not specify the duration over which to consider “subsequent” losses. A key consideration might be whether the actuary considers the no-lapse guarantee a standalone benefit feature or one element within the overall insurance benefit function (as discussed in Q11 and Q15 above). Some actuaries might believe it should be considered on a standalone basis, and may then believe it would be appropriate to test for profits followed by losses and to establish any additional liabilities over the 5-year horizon. Other actuaries might believe it should be considered in combination with other insurance benefits in the contract, and may then believe it would be appropriate to test for profits followed losses and establish any additional liabilities over the policy lifetime. In either case, whether or not a liability in addition to the account balance is actually held would depend on the specifics, i.e., level of charges and expected losses, together with general GAAP materiality considerations.

Q21. Is testing for profits followed by losses done at issue only, or is this testing updated as actual experience emerges?

A21. Paragraph A28 of the SOP says, *“Similarly, the comparison of the timing of expected assessments and related benefits for determining whether the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function would occur at inception only, as well.”* Many actuaries believe this means that this test would usually be performed at issue only, with exceptions applicable to inforce business at initial implementation of the SOP, and for the reinsuring company upon assuming reinsurance on inforce contracts.

Q22. How are the additional liabilities for insurance benefits generally determined?

A22. The methodology is prescribed in paragraphs 26 through 28 of the SOP. The first step is to calculate the benefit ratio (BR) by the following formula:

$$BR = \frac{\text{Present value of cumulative actual plus future expected excess benefits}}{\text{Present value of cumulative actual plus future expected total assessments}}$$

This ratio is similar to the ratio used in significance of risk testing. Similar to significance of risk testing the benefit ratio is based on future expected experience over a full range of scenarios, rather than on a single set of best estimate assumptions. Other than the need to consider a range of scenarios, paragraph 26 of the SOP states, *“In calculating the additional liability for the insurance benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of amortizing capitalized acquisition costs.”*

The next step is to calculate the liability as defined in the SOP on a retroactive basis by the following formula:

$$\begin{array}{l} \textit{Additional} \\ \textit{Insurance Liability} \end{array} = \textit{BR} * \textit{cumulative actual assessments minus cumulative} \\ \textit{actual excess payments, all accumulated with interest}$$

To ensure mathematical consistency of the formula, the interest rate accreted to the liability would be the same as the discount rate used in determining present values. Some actuaries thus believe the interest rate applied to the liability would be the same as the discount rate. Given the language quoted above from paragraph 26, some further believe this would be the same rate as used to discount and accrete interest in the calculation of DAC. (See Q23 for a further discussion of this interest rate.)

Conceptually, the BR represents the “net premium” funding of expected benefit costs where the net premium is expressed as a constant percentage of the assessment base. The liability accounts for the difference in past payments to date from their levelized expected costs. Paragraph 27 of the SOP requires periodic review and unlocking as for DAC, and states, “*The insurance enterprise should regularly evaluate estimates used and adjust the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised.*” Paragraph 26 of the SOP states that the BR may exceed 100%. The actuary would usually be prudent to evaluate whether a premium deficiency reserve is needed in this situation, considering factors such as the level at which the company tests for premium deficiencies and the materiality of this insurance benefit feature.

Finally, paragraph 28 of the SOP states that the additional insurance liability may not be less than zero.

Q23. What discount rate would be used for calculating present values in determining the benefit ratio?

A23. As discussed in Q22, some actuaries believe paragraph 26 of the SOP requires use of the same discount rate as for DAC. Under paragraph 22 of FAS 97, this is the credited rate and not an assumed asset earnings rate. Paragraph 25 of FAS 97 allows for two options for determining the DAC discount rate, (a) a single rate from inception or (b) a rate updated to reflect experience. Although paragraph 26 of the SOP requires that benefits and assessments be projected over a range of scenarios to determine the benefit ratio, some actuaries might believe it would not be appropriate to use a path-dependent interest rate for present valuing.

Q24. How many scenarios are generally used to meet the requirements of the SOP?

A24. Some actuaries believe that where insurance benefits do not vary significantly with capital markets volatility, one or several deterministic scenarios may be sufficient. Where insurance benefits do vary significantly with capital markets, paragraphs 25 and 26 of the SOP require consideration of a range of scenarios. The general approaches the actuary might consider include the following:

1. One approach might be to project a stochastic set of scenarios. The actuary would consider evaluating whether there are a sufficient number of scenarios such that the results would not change materially as additional stochastic scenarios were added. A technique some actuaries might employ would be to test on a sample of the business how results converge as the number of stochastic scenarios is successively increased.
2. Another approach might be to identify a set of representative scenarios, or even a single representative scenario. The scenarios could be deterministic or could be periodically generated afresh based on current market conditions. Either way, the actuary would usually be prudent to be able to support the conclusion that the representative scenario(s) provide results consistent with consideration over a range of equity market movements. One technique might be to generate a set of stochastic scenarios and then identify a subset that produce results representative of the bigger stochastic set. Another technique might be to apply analytical consideration of likely equity market movements together with analysis of the path dependency of the benefit features in deriving appropriate representative scenarios.

The impact of a range of scenarios on both the benefits and the assessments normally would also be considered.

Q25. Does the SOP require consideration of a range of mortality and/or policyholder behavior scenarios?

A25. In some cases, testing a range of mortality or policyholder behavior assumptions may be appropriate. For example, a no-lapse UL guarantee would usually depend in large part on future interest rate levels, but could depend as well on how richly policyholders fund their contracts. The actuary might want to consider evaluating whether a variation in the funding level is significant to the benefit and whether a range of funding levels should be considered.

Some actuaries believe, however, that the intent of the SOP is to require testing of a range of results for only the key drivers of any additional insurance reserves, but not necessarily to have to test a range for each and every possible variable outcome. Typically this means considering a range of economic scenarios, i.e., interest rate levels and equity market changes. To the extent practical and applicable, some actuaries also believe one would usually base assumptions made about policyholder behavior on formulas that appropriately reflect the expected relationship to capital market conditions, for example, excess lapses based on the projected differential between credited rates and market rates.

Some actuaries might believe it would usually be appropriate to have more refined models by considering stochastic mortality scenarios.

Q26. How does the actuary usually determine the BR from a range of scenarios tested?

A26. Paragraph 26 of the SOP defines the BR as the ratio of “*expected*” values. Some actuaries believe it would usually be appropriate to determine the expected value as the mean result when considering a range of values. One approach is to calculate the mean BR as the mean of the present value of benefits across all scenarios divided by the mean of the present value of assessments across all scenarios. This provides for internal consistency in some methods of calculating the additional insurance liabilities and DAC (see Q30 below).

Another approach would be to calculate the BR for each scenario and simply take the mean of these ratios. However, a consideration when applying this method is that the BR could be very high for the adverse scenarios when both benefits are large and assessments are small, e.g., in projecting results for a variable annuity MGDB. Some actuaries believe this could skew results in some situations and create an unduly conservative value for the mean BR.

Some actuaries might choose alternate measures for the BR, for example, for practicality reasons or because it is felt the scenarios are not all equally likely. Some examples might be: the use of a percentile ranking; choosing a representative scenario(s) among the projected set; or calculating the expected value by assigning weights to the scenarios tested.

Q27. I determine my benefit reserve using a stochastic set of scenarios. If I am using a mean reversion approach for DAC amortization, how would I make my benefit liability return assumptions (which are stochastically generated) consistent with my DAC return assumptions during the mean reversion period?

A27. The actuary might consider various approaches, including the following three:

1. Some actuaries might use the mean reversion rate as the mean return in a stochastic generator during the mean reversion period and use the long-term rate as the mean return for subsequent periods.
2. Some actuaries might use the base return assumption (prior to mean reversion) as the mean for purposes of generating stochastic returns, and either: (a) ignore mean reversion for purposes of the additional insurance reserve under the SOP; or (b) adjust all scenarios by x basis points in the mean reversion period, where x is the difference between the long-term rate and the mean reversion rate.

3. Some actuaries might use a mean return assumption in all periods at some level between the mean reversion rate and the long-term rate.

Q28. At what level of aggregation is it usually appropriate to calculate the BR for a set of contracts?

A28. The SOP does not specifically address the level of aggregation for BR (note that FAS 97 likewise does not address specifically the level of aggregation for DAC). Some actuaries note that the SOP requires the estimated gross profits (EGPs) used in calculating DAC to take into account changes in the additional insurance liability, and they therefore believe it is usually appropriate to calculate the BR and consequent liabilities at the same or some lower level of aggregation as that used in calculating DAC.

Q29. At what level of aggregation is it generally appropriate to floor any additional insurance benefit liabilities at zero?

A29. The SOP does not address the level of aggregation for the zero floor. Some actuaries believe this would typically be done at a very low level of aggregation, even possibly at the benefit feature level within each individual contract, whereas other actuaries feel higher levels of aggregation would usually be proper and supportable. Items a company might wish to consider include: the practicalities of its calculation processes; the level of detail desired for internal reporting and analysis; the method used and level of detail required to reflect the additional insurance liabilities in estimated gross profits used for DAC amortization; and the level at which DAC recoverability testing is performed. Whichever level is determined appropriate by the actuary would be consistently maintained.

Q30. The SOP requires that estimated gross profits (EGPs) used for amortization of DAC be adjusted to reflect the recognition of any additional insurance liabilities, and that assumptions for EGPs and these liabilities be consistent. How would the actuary typically reconcile EGPs and liabilities when EGPs are based on a single set of best estimate assumptions and liabilities are based on a range of values?

A30. The actuary might consider various approaches, including the following two:

Determine projected EGPs by simply using the mean results over the range of scenarios, i.e., the mean value for assessments, the mean value for contract expenses and the mean value for paid benefits. This would typically be done for each projection period separately. This ensures internal consistency, specifically, the additional insurance liabilities would be projected to amortize down to zero within the projection period. (This holds true provided the BR is determined as the present value of benefits summed over all scenarios divided by the present value of assessments over all scenarios, and where present value is done at the same discount rate as used for additional insurance liabilities and DAC.) The actuary would usually find it prudent to be comfortable with the results, given the fact that the EGPs typically cannot be related to a single best estimate scenario but instead reflect the end result of a stochastic projection.

1. Determine the BR using a range of scenarios as above, project future assessments and expenses deterministically on the basis of a single set of best estimate assumptions, and calculate EGPs as the best estimate assessments less the best estimate contract expenses and less incurred claims determined as BR times the best estimate assessments. Note there usually would be no need for an explicit projection of paid benefits or changes in the additional insurance liabilities under this method. This approach, however, might not automatically reflect any impact on incurred benefits of flooring the liability at zero, and might not be appropriate if the company chooses not to include interest on liabilities in the adjustment made to EGPs (see Q31).

Some actuaries might use variations on these general methods. For example, under the second method above, some actuaries might choose to use existing projections of future paid benefits such as might be available from the company's recent plan or risk management forecasts. Incurred benefits would then be determined as paid plus change in liability; the actuary would then project out a path for the current additional insurance liability to be eventually amortized to zero (the liability could potentially increase before decreasing, and could potentially be subject to a zero floor at times).

Q31. When reflecting the change in additional insurance liabilities in EGPs, would the actuary also increase EGPs by investment income from assets supporting these liabilities?

A31. The SOP is not specific on this point and states merely in paragraph 29 that, “*The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect recognition of the liability in accordance with paragraph 28 of this SOP.*”

Conceptually, some actuaries might believe it would be appropriate to adjust EGPs for interest on the additional insurance liabilities. This issue can be laid out by considering the following equations:

$$(1) \text{ EGP}_t = \text{Assessments}_t - \text{Contract Expenses}_t - \text{Paid Benefits}_t - \text{“Adjustment}_t\text{”}$$

$$(2) (\text{Liability}_t - \text{Liability}_{t-1}) = \text{BR} * \text{Assessments}_t - \text{Paid Benefits}_t + \text{Liability Interest}_t$$

The SOP does not stipulate how to apply the “*Adjustment*,” but one interpretation is simply to apply the change in the additional insurance liability. Substituting $(\text{Liability}_t - \text{Liability}_{t-1})$ for “*Adjustment}_t\text{”* in equation (1) gives:

$$\text{EGP}_t = \text{Assessments}_t - \text{Contract Expenses}_t - \text{Paid Benefits}_t - (\text{Liability}_t - \text{Liability}_{t-1}), \text{ or}$$

$$(3) \text{ EGP}_t = \text{Assessments}_t - \text{Contract Expenses}_t - \text{BR} * \text{Assessments}_t - \text{Liability Interest}_t$$

As can be seen in equation (3), reflecting the additional benefit liabilities in EGPs not only replaces paid benefits with a levelized funding cost equal to “*BR * Assessments*” but also reduces EGPs by interest accreted to the additional liability balance. Some actuaries

might believe it is typically appropriate to add this interest cost back in to EGPs so the periodic benefit cost reflected in EGPs is a constant percentage of assessments. In effect, the “*Adjustment*” would be determined as change in liability plus interest on the liability, rather than change in liability alone. In this case, the additional interest adjustment would usually be determined at the same rate at which interest accretes to the liability.

Alternatively, the actuary might think of interest on assets supporting the liability as a component of investment margin since the GAAP liability under the SOP is comprised of account balance plus additional insurance liabilities. In this case, interest would typically be determined at the portfolio earned rate. However, paragraph 23 of FAS 97 states that EGPs should include “*amounts expected to be earned from the investment of policyholder balances.*” Some actuaries might read this restrictively to mean EGPs should not be adjusted to include investment income on assets supporting additional insurance liabilities. On a technical point, then, interest on the additional liability might be better characterized under GAAP as a component of the adjustment to EGPs for the additional insurance liabilities (i.e., use of the liability rather than portfolio rate).

Other actuaries note that the illustration provided in Appendix E of the SOP does not adjust EGPs to include investment income on assets supporting additional insurance liabilities. So, while conceptually appropriate, some actuaries might believe it is not required to adjust EGPs for interest on liabilities, while other actuaries might believe it is not even permitted.

Q32. My product has non-level revenue items requiring an unearned revenue liability (URL) and also has insurance benefit features requiring additional liabilities. How would I do the calculations, as there appears to be an interdependence of these items?

A32. Paragraph 26 of the SOP notes that certain front-end fees would require deferral and amortization as a URL under FAS 97. In such case, paragraph 26 states, “*The amounts recognized in income should be considered assessments for purposes of this paragraph.*” Interdependence arises, as the URL is dependent on EGPs that are dependent on additional insurance liabilities, and the additional insurance liabilities are dependent on assessments that are dependent on the URL. Mathematically, an iterative approach is typically used to solve for a circular relationship; an iterative approach might then be considered when a product has non-level revenue deferred as a URL and also has features requiring additional insurance liabilities. An example might be a UL with policy fees charged for the first ten contract years only, and with a no-lapse guarantee.

An iterative approach could be applied as follows:

1. Calculate the interim EGP stream by ignoring the additional insurance liabilities, and use these to determine the interim stream of URL balances. Note that the final EGP stream is unknown until the BR and additional insurance liabilities have been determined.

2. Determine the interim incurred assessments by adjusting collected assessments by the changes in interim URL. Use this stream for determining the interim BR and interim stream of additional insurance liabilities.
3. Use the interim stream of additional insurance liabilities to determine the adjusted EGP stream.
4. Use the adjusted EGP stream to determine the adjusted stream of URL. If not close to the interim URL, iterate back through steps 2 through 4 above. (For practicality reasons, it might often be sufficient to stop at step 4.)

Another approach would be to first calculate the BR using all assessments excluding the change in URL. Then calculate EGPs, including the estimated benefits and liabilities associated with the insurance benefit feature. Then the URL amortization could be recalculated and the change in URL included in assessments. If the assessments including the change URL do not differ significantly from those without change in URL, no additional analysis generally would be required. If they do differ, the iterative process could be repeated until the difference became insignificant.

Q33. The SOP requires regular evaluation of the additional insurance liability and restatement as necessary. Is this linked to periodic review and unlocking of DAC?

A33. Some actuaries believe these two items are closely linked, as the BR and additional insurance liability get restated as needed in a manner analogous to how the k-factor and DAC get unlocked. Past actual assessments and paid benefits are generally used, and expected future assessments and paid benefits typically get reprojected based on the current inforce and current set of assumptions (future projections are done under a range of scenarios under paragraph 26 of the SOP).

Some actuaries believe it would be logical to first review the BR and additional insurance liabilities before a DAC review. To the extent the BR and insurance benefit liabilities are changed, this would usually impact the EGP stream for DAC.

Some actuaries observe there is a subtlety in the review requirements, as follows: the BR and additional insurance liabilities are subject to review when evidence suggests assumptions need to be changed (paragraph 27 of the SOP), whereas DAC is subject to unlocking when evidence suggests EGPs need to be changed (paragraph 25 of FAS 97). It may be possible that situations will arise where the company determines that only the additional insurance liabilities or only the DAC would be unlocked. For example, changes in contract expenses typically would impact DAC but not the insurance liability.

Q34. For variable products, would one usually include or exclude investment advisory and other investment fund based fees from the calculation of assessments?

A34. Paragraph 26 of the SOP states, “*Total expected assessments are the aggregate of all charges, including those for administration, mortality, expenses, and surrender,*

regardless of how characterized.” Some actuaries note the words “*all charges ... regardless of how characterized,*” and read this to include investment advisory and other fund-based fees. Some actuaries also note that the same fees could be characterized as either account balance or fund-based. For example, it is possible to design a variable product with zero fees charged the policyholder and margins taken by the company out of the investment funds. Some actuaries may believe then that charges that are revenue to the company would appropriately be included, whether account balance based or fund-based, and whether collected by the company or by an external fund manager (to the extent they are shared with the insurance company).

Other actuaries note that the examples of assessments given in paragraph 26 of the SOP are those applicable to account balances, and interpret this to mean assessments would appropriately include only those items charged directly to the policyholder.

While there could be a difference in the result of the significance test based on what is included in the assessment base, the two approaches would likely result in similar additional insurance liability levels since it is the pattern rather than the level of assessments that typically determines the liabilities held.

Q35. What relationships do the additional GAAP MGDB and GMIB liability levels have with corresponding statutory reserves (i.e., in explaining results to management and external analysts)?

A35. The calculations are fundamentally different and the amounts will likely not have a stable relationship. The additional GAAP liabilities for insurance benefits are usually based on the amounts assessed for the benefits over the policy lifetime and a benefit stream that is determined using a range of scenarios. Statutory reserves are usually based on the net amount at risk (NAR) exposure as of reporting date and deterministic assumptions. In the case of GMIB and other guaranteed living benefits, there is a floor of past accumulated rider fees. However, the statutory reserve is additionally subject to standalone cash flow adequacy testing based on the NAR as of the reporting date. Further, there is a revised valuation law in development under which statutory reserves for all VA guarantees would be based on cash flow type testing and thus reflect current market exposure.

For example, consider a newly issued block where a change in the capital markets creates a large NAR. Statutory reserves would reflect the current NAR exposure. Under GAAP, the BR would increase and the rate of future funding of the liability would go up. However, the current liability balance typically would go up by only the change in BR applied to past assessments (liability increase would likely be minimal for newer issued blocks).

As another example, assume a favorable market change in the capital markets that makes the chance of future payout small. Statutory reserves could be zero if the market improvement were sufficiently favorable. Under GAAP, the BR would be reduced but liabilities might still be positive.

Section C: GAAP Liabilities for Minimum Annuitization Guarantees

Q36. What are the considerations in determining whether an annuitization option might require a liability to be held in addition to the base reserve of the account balance?

A36. The actuary would usually take into account the following considerations:

1. Paragraph 31 of the SOP states, “*an additional liability for the contract feature should be established if the present value of expected annuitization payments at the expected annuitization date exceeds the expected account balance at the expected annuitization date.*” So, the first step would usually be to assess whether there is potential at some or all future annuitization dates for expected excess payments, i.e., present value of annuitization benefits in excess of the account balance (see Q39 for discussion on present valuing). If so, one would then consider the expected rates of future annuitization.
2. Unlike for insurance benefits, the SOP does not prescribe a significance test or a test at inception for profits followed by losses. Also, the SOP does not stipulate that the deferred contract be insurance or investment only, and does not stipulate that the expected annuitization payments be life contingent or certain. Some actuaries believe that it would therefore be appropriate to hold an additional liability for annuitization options whether the contract is insurance or investment, and whether or not life contingent annuitizations are offered. Also, some actuaries believe this applies equally to traditional and nontraditional products.
3. The SOP is applicable only when the annuitization option does not fall under FAS 133 (paragraph 31 of the SOP).

In brief, the SOP might require an additional liability if the present value of future annuitization payments is expected to exceed the account balance available at annuitization.

Q37. What are examples of annuitization options that have potential for benefit payments in excess of that provided by the account balance, and specifically what account balance typically would be used?

A37. Paragraph 31 of the SOP provides as examples annuity purchase guarantees, guaranteed minimum income benefits (GMIB) and two-tier annuities. Additionally, some actuaries believe it would usually be appropriate to evaluate any annuitization option provided by a fixed or variable deferred annuity contract or as a settlement option

on a life contract to determine whether there is a potential for excess annuitization payments.

Paragraph 31 of the SOP refers to the “*accrued account balance*” in testing for excess annuitization benefits. The SOP states in the Summary section “*the accrued account balance should be based on the highest contractually determinable balance that will be available in cash or its equivalent at contractual maturity or reset date, without reduction for future fees and charges.*” Some actuaries believe that when testing for excess annuitization benefits the appropriate account balance typically would be the highest balance available in cash before surrender charge or market value adjustment. For example, the lower account balance tier usually would apply in the case of a two-tier annuity.

Q38. How are the additional liabilities for annuitization options usually determined?

A38. Paragraphs 31 through 33 of the SOP prescribe a methodology analogous to that prescribed for the calculation of additional insurance liabilities. An additional liability for annuitization options typically would be based on a BR, would be subject to a zero floor, would be subject to periodic assessment and restatement, and would be subject to the same reinsurance assumed considerations. Further, EGPs used for amortization of DAC would reflect the change in this liability (paragraph 34 of the SOP).

Many of the issues that apply to additional insurance liabilities may also apply to the additional liability for annuitization options, and the comments in section B might be applicable. The assumptions used in calculating the BR usually would use expected experience based on a range of scenarios that consider the inherent volatility in the assumptions; the expected annuitization election rate is one of the assumptions that would be estimated (paragraph 31 of the SOP).

Q39. What interest rate and other assumptions would be used in determining present values when determining the additional liability for annuitization options?

A39. There are two periods of discounting to consider, namely the annuity payment phase, and the accumulation phase until annuitization, as follows:

1. Paragraph 31 of the SOP sets the interest rate to be used for present valuing benefits and related claim expenses during the annuity payment period as the “*estimated investment yields expected to be earned during the **annuitization** phase of the contract.*” Some actuaries believe this would imply use of a rate consistent with that expected to be earned by the company at that time from new premium. Some actuaries believe it would usually be appropriate to use an earned rate net of allowance for asset defaults and net of allowance for investment expenses and for all other non-claim related expenses. Also, they might believe the earned rate would be gross of allowance for any profit margin. Use of this earned rate would typically result in an excess benefit (excess of present value of annuity payments and related

claim expenses over the account balance), in the event annuitization would result in an expected loss to the company.

Where annuity payments include life contingencies, some actuaries might believe an appropriate mortality assumption would anticipate ongoing future improvements in mortality. Some actuaries might interpret the SOP to allow for provisions for adverse deviation when determining the present value of life contingent annuity payments, i.e., by reductions in the assumed earned rate and mortality rates. Other actuaries might believe the SOP does not require use of margins, or might even not permit use of margins.

2. The actuary would determine the present value of the excess benefits during the accumulation period to determine the additional liability. Paragraph 31 of the SOP requires use of assumptions consistent with those used in estimating EGPs for DAC, including consistency with the interest rate. Some actuaries believe it is therefore appropriate to use a rate consistent with that used for DAC and additional insurance liabilities.

Also, present valuing during the accumulation period typically involves assumptions as to expected rates of future annuitizations, and some actuaries interpret the SOP to require consideration of a range of scenarios where volatility is inherent. Some actuaries believe the other assumptions used for the accumulation period such as mortality and persistency appropriately would be based on best estimates without margins for adverse deviation (to be consistent with estimating EGPs for DAC).

Q40. How would the SOP apply to a variable immediate annuity with a guaranteed payout floor that is accounted for under FAS 133?

A40. Once the contract is bifurcated during the payout phase according to revised Derivatives Implementation Group Issue B25 (DIG B25), the benefits valued under FAS 133 would be outside the scope of the SOP. Some actuaries believe those benefits not valued under FAS 133 would fall within the scope of the SOP (see Q5).

Q41. For a two-tier product, would the additional liability be calculated as the present value of the difference between the expected upper tier and the lower tier account values at annuitization?

A41. Paragraph 31 of the SOP states that the additional liability is the difference between the present value at the assumed earned rate of expected annuity payments and related expenses and the accrued account balance at the actual annuitization date. In certain situations, it might occur that the upper tier equates to the present value of expected annuity payments and the lower tier equates to the accrued account balance.

Q42. My annuitization options are generally conservative and unlikely to provide excess benefits except in the most remote of circumstances. Would I ignore this remote contingency on the grounds of being immaterial?

A42. If the additional liability for annuitization options would be immaterial, the actuary might decide not to hold it. The actuary might find it prudent, however, to demonstrate immateriality based on analysis over a range of scenarios. Some actuaries might believe this analysis is beneficial only at inception. Other actuaries, however might note that, unlike for additional insurance liabilities as discussed in paragraph A28 of the SOP, there is no at-inception-only test for excess annuitization benefits and thus one might wish to later establish an additional liability for annuitization options if events turn out unfavorable.

Q43. Does existence of an annuitization option typically extend the expected lifetime of the contract?

A43. Paragraph A39 of the SOP and paragraph 7 of FAS 97 state in regard to annuitization options, *“If purchased, the annuity is a new contract to be evaluated on its own terms.”* Some actuaries therefore believe that the annuitization phase typically would be considered apart from the accumulation phase, and therefore the additional liability for the annuitization option, as well as any additional insurance liabilities, DAC and deferred sales inducements, would be determined over the contract’s accumulation period only.

The additional liability represents a pre-funding of a potential future benefit during the accumulation stage; upon annuitization, the account balance plus any additional liability represent the “premium” for the new annuitized contract (per two-tier example in paragraph D5 of the SOP). The annuitized contract usually would be evaluated at that time for characterization as an insurance or investment only contract.

Q44. How would the actuary reserve for a contract that annuitizes “in-the-money”? How would profits then typically emerge at point of annuitization and thereafter?

A44. As noted in Q43 above, a “premium” is released from the terminating contract (accumulation phase) and a liability is established for the new contract (annuitization phase). Profit or loss upon annuitization typically would then result from any difference in “premium” over the initial liability established at point of annuitization. The “premium” is comprised of the account balance plus any amounts such as for additional insurance liabilities, additional liability for annuitization options and accrual for sales inducements, less any DAC and other assets held on that contract. The liability at annuitization would normally be determined as follows:

1. If benefits are certain only, the payout annuity would generally be an investment only contract and initial liability would be set equal to “premium,” less any deferrable acquisition costs incurred at annuitization.

2. If benefits include life contingencies, the payout annuity would generally be a limited-payment contract under FAS 97. The initial liability generally ends up exactly equal to “premium” less deferrable acquisition costs for reasons discussed here. The initial liability would be the present value of benefits and expenses and could include provisions for adverse deviations. However, if the annuitization option liability were calculated without provision for adverse deviations (see Q39 above), the initial liability likewise would not contain such provisions (FAS 60 requires provisions be removed to the extent needed to avoid a premium deficiency). Finally, there would be no profit recorded at annuitization because a deferred profit liability would then otherwise be held under FAS 97.

Based on the considerations above, generally no profit or loss would be recorded at annuitization. Further, the annuitization option liability would typically be calculated based on “paid” benefits equal to any excess of liability at annuitization over the account balance available in cash. Given the many and uncertain assumptions going into the additional annuitization liability calculation, there would likely be periodic unlocking with resultant gains or losses recorded during the accumulation phase.

During the annuitization phase, profits or losses typically would be expected to emerge to the extent actual experience emerged different than expected and as provisions for adverse deviation, if held, were released.

Section D: Sales Inducements

Q45. What are sales inducements?

A45. These are defined in the glossary of the SOP as follows: “*Sales inducements are product features that enhance the investment yield to the contract holder on the contract. The three main types of sales inducements are: (1) day-one bonus, which increases the account value at inception, also called immediate bonus; (2) persistency bonus, which increases the account value at the end of a specified period; and (3) enhanced yield, which credits interest for a specified period in excess of rates currently being offered for other similar contracts.*”

Per the SOP then, sales inducements provide an enhanced investment yield. Some actuaries interpret these as purely interest or yield related benefits, whereas, other actuaries believe items credited the account balance that are in substance, if not in name, equivalent to an interest credit would be considered as well. For example, they might consider premium credits provided at contract issue under many variable annuity contracts to be day-one sales inducement bonuses.

Q46. Are all persistency bonuses sales inducements? In particular, what about persistency bonuses of refund of COIs for a UL?

A46. Paragraph 61 of FAS 97 states, “*The Board also concluded that amounts assessed against policyholder balances that are refundable and amounts that are assessed for initiation of a universal life-type contract are unearned revenues.*” Some actuaries therefore believe that refund of COIs for a UL, together with similar benefits of full or partial refund of other contract expense charges or loads, would be treated as unearned revenue under FAS 97 and not as sales inducements under the SOP.

Q47. If a company credits a higher interest amount starting in a specific year and continuing for the remaining life of the contract, (e.g., crediting rates are increased by 15 basis points over the company’s usual crediting rates starting with the 11th contract year, or M&E charges for a variable contract reduce for policy years 16 and later), would this be treated as a sales inducement under the SOP?

A47. The answer would depend on the facts and circumstances. In the case of increasing interest credits, some actuaries might regard this as a sales inducement as additional interest is being credited upon contract persistency. If the actuary determines this is a sales inducement (essentially a series of persistency bonuses), she or he would follow the SOP guidance for establishing a sales inducement liability and possibly a companion asset (see Q48).

Other actuaries, however, might regard this a regular part of contract benefits rather than as an enhancement. If the actuary determines this is not a sales inducement, she or he would then decide how to account for this benefit feature. One approach is to not accrue an additional liability (i.e., hold the account balance) and simply reflect the increased interest credits in EGPs. Another potential approach, in the case of an investment contract, is to apply the FAS 91 interest method of recognition for non-level interest (this would essentially smooth out the credited rate and might produce the same result as treating the benefit as a sales inducement).

In the case of decreasing M&E charges, some actuaries might believe the benefit is not a sales inducement as there is no enhanced crediting of interest or yield. Other actuaries, however, might believe the reduction in M&E is equivalent to the crediting of additional amounts to the contract, and would usually follow the considerations discussed above for the example of increasing interest rates.

Q48. How would sales inducement liabilities be computed?

A48. Paragraph 36 of the SOP states, “*Sales inducements provided to the contract holder, whether for investment or universal life-type contracts, should be recognized as part of the liability for policy benefits over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraph 20 of this SOP.*”

Based on the above, day-one sales inducements typically would be added to the account balance at the inception of the contract or immediately thereafter. If a day-one bonus stipulates that the contract must persist for several years before it becomes available, the total bonus would still be added to the account balance immediately despite the fact that the bonus would not yet be converted to cash (per paragraph 20 of the SOP the liability would be accrued over “*the crediting date, if earlier*”). By design then, day-one sales inducements costs are recognized upfront in the account balance and no additional liability is needed.

Enhanced yields are typically credited to the account balances daily, monthly or annually. As above, if an enhanced yield bonus stipulates that the policy must persist for several years before it becomes available in cash, the credits would still be added to the account balance as fall due despite the fact that the bonus would not yet be converted to cash. The SOP requires amounts accrued but not yet credited to be included in the account balance. No additional liability is then needed.

Persistency bonuses are normally credited at a future date and are not added to the account balance until that date. An additional liability therefore would be computed. The language in the SOP does not mention a specific methodology but does provide guidance that it be treated as an interest rate adjustment in the case of FAS 91 investment contracts (SOP paragraph A51), or that it be done ratably (SOP appendix D). There are several different methods that can be described as ratably, for example, accruing ratably as a level percent of account balance which is equivalent to determining a level yield enhancement. Other methods that are more tailored to specific product designs can also be described as ratably, for example, a level percent of death benefits, assessments, or EGPs, or even a fixed amount per contract.

A consideration is how to maintain the liability on track to accrue up to the persistency bonus, for example, the bonus amount might depend on the account balance at the time the bonus is credited. Some actuaries might feel it is appropriate to adjust the rate of accrual prospectively, whereas other actuaries might feel it is appropriate to adjust the liability retroactively as for DAC unlocking. Either way, it would usually be prudent to periodically review the accrual of liability and adjust for actual experience.

Q49. Do all sales inducement liabilities produce an associated sales inducement asset?

A49. This does not appear to be the case. Paragraph 37 of the SOP defines specific conditions for when a sales inducement liability leads to establishment of a companion sales inducement asset.

First, the SOP requires that the sales inducement be “*explicitly identified in the contract at inception.*” So, benefits provided after the contract has been in force might require accrual of a liability but would not necessarily permit an asset, for example, management adding a persistency bonus to preserve an inforce block of business.

Second, the SOP requires evidence that the benefits provided are enhancements to the normal crediting of benefits. Specifically, the SOP states, “*The insurance enterprise should demonstrate that such amounts are (a) incremental to amounts the enterprise credits on similar contracts without sales inducements and (b) higher than the contract’s expected ongoing crediting rates for periods after the inducement, as applicable; that is, the crediting rate excluding the inducement should be consistent with assumptions used in estimated gross profits, contract illustrations, and interest-crediting strategies.*” In some cases the demonstration might be self-evident, for example, universal life where the sales illustration shows a first year credited rate clearly in excess of a level renewal year rate. Other cases, however, might involve comparison with a similar product without the sales inducement and/or internal company documentation on product management.

Q50. In considering the criteria for deferral of a sales inducement, what would a company do if it did not offer a similar contract without a sales inducement?

A50. Some actuaries believe comparison with a similar product offered by the company but without the sales inducement is a sufficient but not a necessary condition. They might note paragraph A54 of the SOP, which states “*In cases where a similar product is not actively marketed and sold without the enhanced crediting rate, AcSEC believes the enterprise should demonstrate that the enhanced crediting rate is incremental to the effective crediting rate.*” Paragraph A54 then discusses and provides an example of an alternate demonstration the company could use. Specifically, where there is no similar product without a sales inducement, it states the enterprise should demonstrate that the enhanced credited rate is incremental to the effective crediting rates on the enterprise’s other products that have common characteristics.

Q51. How does the calculation of the sales inducement liability typically affect the sales inducement asset?

A51. A sales inducement asset is usually computed by deferring and amortizing sales inducement costs in the same manner as for DAC. Paragraphs 37 and A58 of the SOP describe the treatment that should be given. The amount to be deferred in any period of time is typically the incurred sales inducement cost for that period; specifically, the incurred cost would usually comprise bonus amounts credited to the account balance, additional bonus amounts accrued to the account balance under paragraph 20 of the SOP, and changes in the sales inducement liability.

Note that the liability and asset need not exist for the same time period. For example, consider a persistency bonus credited at the end of year five. The sales inducement liability builds up over the first five years with the changes in liability deferred in the sales inducement asset. At year five, the amount credited would be offset by an equal write down to zero of the sales inducement liability, with no further changes in the liability or amounts deferred from that time forward. Note that the sales inducement liability in the example would then exist over the first five years only, whereas the sales inducement asset would exist over the contract lifetime (as for DAC, the asset is amortized over the contract lifetime). The impact of accruing a sales inducement liability

and amortizing a companion asset typically is effectively to have the persistency bonus expensed in a levelized manner over the contract's lifetime.

Q52. How are sales inducement assets and liabilities usually reported?

A52. On the balance sheet, the sales inducement asset is usually reported as an asset separate from DAC, and the sales inducement liability is reported as part of contract liabilities. On the income statement, amortization of the sales inducement asset and changes in the sales inducement liability are both usually classified as a component of benefit expense. (See paragraph 37 of the SOP).

Q53. Does the SOP require the actuary to assume that all contracts persist to earn their persistency bonuses when computing the sales inducement liability?

A53. Paragraph 36 of the SOP states, "*No adjustments should be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features.*" Many actuaries interpret this as requiring the sales inducement liability to be calculated assuming all those currently in force will persist to collect their bonuses. A secondary consideration is treatment of exits due to death or morbidity; some actuaries might consider these different than persistency and allow for assumed decrements.

Other actuaries, however, might interpret the SOP language as effectively two steps as follows: (a) determine an appropriate liability that the actuary expects to eventually pay out; and then (b) accrue to this amount without any adjustment for persistency. They might interpret step (a) as projecting the persistency benefits based on best estimate assumptions including appropriate allowance for persistency. If exits are not assumed, the actuary might consider the liability to be over-estimated. Step (b) would then be to accrue up to this amount. In step (b) it would be appropriate to assume 100% persistency. Many actuaries, however, disagree with this interpretation.

To illustrate the two varying interpretations, consider an example where \$1,000 is paid at the end of 10 years and 80% are expected to persist. The first interpretation above is to assume 100% persistency and accrue up to \$1,000 per contract. The alternate interpretation is (a) to determine an \$800 expected liability per contract (80% chance of payout of \$1,000), and then (b) accrue up to this amount for each contract. (Note that it would be inappropriate under step (b) to both adjust for persistency and accrue to only 80% of the \$800 or \$640 per contract.)

Q54. How would the actuary reflect sales inducements in the EGPs stream for purposes of amortization of DAC and related items?

A54. This is not explicitly covered in the SOP. However, where a companion sales inducement asset is held, some actuaries believe it is usually appropriate to exclude the incurred sales inducement benefits from EGPs. This would be consistent with treatment of other items that are deferred, such as deferrable acquisition costs and unearned revenue, and that are likewise excluded from EGPs. (Note that the incurred sales

inducement benefits typically are deferred and amortized within the sales inducement asset).

Where no sales inducement asset is held, some actuaries believe it is appropriate to include sales inducement benefits in the EGPs on an incurred basis, i.e., paid plus change in sales inducement liability. This would be consistent with treatment of benefits for which an additional insurance liability is held. (Note, as per Q31, some actuaries might believe it appropriate to add interest on the sales inducement liability to the EGPs).

Section E: Reinsurance

The discussion in Section E covers additional insurance liabilities for contracts covered by reinsurance. Although not specifically mentioned, the same issues and responses usually apply equally, where relevant, to reinsurance credits for additional liabilities from annuitization options and from sales inducements, and to contra offsets to DAC and sales inducement assets.

Q55. For the ceding company, are the significance of risk test and profits followed by losses test for reinsured contracts usually done on a direct basis or net of reinsurance in determining whether additional insurance liabilities are held?

A55. FAS 113 governs the accounting for reinsurance and states in paragraph 13, “*The evaluation of mortality or morbidity risk in contracts that reinsure policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement.*” (Paragraphs 7 and 8 of FAS 97 refer to the significance test for classification as insurance or investment contract).

Based on this language, some actuaries conclude that the significance test for insurance risk would appropriately be assessed net of reinsurance cash flows. Some actuaries also believe this would usually be done as well for the test of profits followed by losses in determining whether to hold an additional insurance liability for the reinsured contract. In this case, adjustments to benefits and/or assessments would usually then be made so that the significance of risk and/or profits followed by losses tests are net of reinsurance. Possible methods for doing so include the following:

1. Benefits are adjusted by the net reinsurance cash flows (benefit recoveries, expense allowances, premium tax allowances and experience refunds less reinsurance premiums). Assessments are unadjusted from their direct value. Note that the non-level portions of reinsurance expense allowances typically would be excluded from net reinsurance cash flows to the extent they are deferred as offsets to DAC.
2. Net reinsurance cash flows are divided into “benefit” and “assessment” components. For example, the actuary might consider reinsurance recoveries to be benefits and all

other cash flows to be assessments. The latter item could be considered the “net reinsurance premium,” as it would comprise reinsurance premiums less various reimbursements from the reinsurer such as expense allowances, premium tax allowances, and possibly experience refunds. Benefits are then reduced by reinsurance recoveries and assessments are reduced by “net reinsurance premiums.” Note that the non-level portions of reinsurance expense allowances would not be included with either benefits or assessments to the extent they are deferred as offsets to DAC.

3. As a variation of approach 2 above, some actuaries might include “net reinsurance premiums” as increases to benefits and decrease assessments by reinsurance recoveries.

If testing is done on a net of reinsurance basis, the actuary would usually be prudent to consider whether to retest for significance of risk and/or profits followed by losses whenever there is a significant change in reinsurance terms, for example, a reinsurance premium rate change or recapture of the business.

Other actuaries may conclude paragraph 13 of FAS 113 could be considered as a separate requirement just for the reinsurance component. Essentially, there is a contract between the policyholder and the direct company, and a separate contract between the direct company and the reinsurer. They might believe then that the significance of risk and profits followed by losses tests would appropriately be done on a direct basis without consideration of any reinsurance cash flows. Separate testing of the reinsurance cash flows typically would then be done to determine whether the reinsurance contract qualifies for reinsurance accounting and whether a reinsurance credit should be established where additional insurance liabilities are held.

Q56. For the ceding company, is reinsurance ceded subject to a separate profits followed by losses test in determining whether a reinsurance credit is held?

A56. Some actuaries might believe it is usually appropriate to calculate reinsurance credits under the SOP in the event the company is holding additional insurance liabilities for the direct benefit, without specifically applying the profits followed by losses test to the reinsurance cash flows. For example, this might be applicable where the actuary has tested the contract on a net of reinsurance basis (first interpretation under Q55).

Other actuaries, however, might prefer to subject the reinsurance ceded contract to an independent profits followed by losses test. In this case, reinsurance credits typically would be calculated only in the event the reinsurance is expected to result in losses followed by profits, i.e., where reinsurance premiums net of allowances are expected to be greater than ceded benefits in early years and less than ceded benefits in subsequent years. For example, this might be applicable where the actuary has tested the contract on a gross of reinsurance basis (second interpretation under Q55)

Q57. Could an additional insurance liability be established in a situation where 100% of the benefits are reinsured?

A57. Yes, it appears application of the SOP could result in additional insurance liabilities being established in a situation where benefits are 100% reinsured. These liabilities might be offset in full or in part by a reinsurance credit, depending on the specifics of the situation, and possibly also depending on the approaches taken under Q55 (application of the significance and profits followed by losses tests). Q56 (determining whether or not to take a credit), and Q58 (determining the amount of reinsurance reserve credit).

Q58. Where additional insurance liabilities are being held under the SOP, how would the actuary for the ceding company calculate reinsurance credits?

A58. The SOP does not specify a methodology for determining reserve credits. FAS113 does not specify a methodology for reserve credits either, but does state in paragraph 20, *“Reinsurance receivables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported and future policy benefits) relating to the underlying reinsured contracts.”* Some actuaries therefore believe that the reinsurance credits (*“reinsurance receivable”*) would appropriately be determined in a manner consistent with the way in which the additional insurance liabilities (*“the liabilities”*) are determined.

For example, if the actuary determines the need for additional insurance liabilities on a net of reinsurance basis (first interpretation under Q55), she or he might believe it is appropriate to determine “net” additional insurance liabilities. The actuary could calculate this net value by using adjusted benefits and/or assessments, for example, using one of the three possible approaches laid out in Q55. The reinsurance credits would then be the difference between the liabilities on a direct basis and the net liabilities.

As another example, if the actuary determines the need for additional insurance liabilities on a gross of reinsurance basis (second interpretation under Q55), she or he might believe it is appropriate to separately calculate the direct liabilities and the reinsurance credits. Various approaches for the reinsurance credits could be considered, including the following two:

1. Define “benefits” as the net reinsurance cash flows (as per Q55), and define “assessments” to be the direct basis values.
2. Define “benefits” as net reinsurance premiums (as per Q55), and define “assessments” as reinsurance recoveries.

Note in both approaches that the non-level portions of reinsurance expense allowances would be excluded from the reinsurance credit calculation to the extent deferred as offsets to DAC.

In some situations, it might be appropriate to account for reinsurance ceded using the practice followed prior to adoption of the SOP. For example, it might be appropriate to

simply hold an unearned reinsurance premium asset or a pro-rata reinsurance credit based on the reinsurance quota share percentage. A consideration with these approaches is that they might, where additional insurance benefit liabilities are established under the SOP, result in a mismatch between direct liabilities and reinsurance credits.

The actuary might want to consider approaches other than those discussed above. There might be differences in current practice as to how actuaries apply FAS 113 for the specifics of each deal and this would be a further consideration in choosing an appropriate method for calculating reinsurance credit.

Q59. How does the SOP impact accounting by a reinsurer assuming risk for a benefit feature falling within the scope of the SOP?

A59. Paragraph 30 of the SOP sets out the rules on this. Essentially, this is treated under analogous rules but considering the reinsurance from the viewpoint of the reinsurer. Some considerations are as follows:

1. The significance test would generally be based on the reinsurer's cashflows and categorization could thus differ from that for the direct issued contract. The test is based on inception of reinsurance for that contract rather than its inception date.
2. The reserving guidance generally applies whether or not there is an account balance (i.e., treated as though FAS97 universal life-type insurance contract). For example, there typically would not be an account balance if only the insurance benefit feature were reinsured.
3. The liability calculation is based on the reinsurance premiums. For example, consider reinsurance of an inforce block with a positive insurance liability. If the reinsurer received essentially level premiums, the insurance liability would start at zero at treaty inception. However, if the reinsurer received an upfront payment for the current exposure to future benefits, insurance liabilities would be established at treaty inception. Regardless, the liability typically would be based on the reinsurer's actual and projected cashflows, and usually would not follow the direct company's calculations.

Section F: Transitional rules for implementation of Statement of Position 03-1

Q60. What is required by the SOP for initial implementation of the accounting change?

A60. Key items for actuaries include: possible restatement of certain base liabilities in terms of which account balances to use; identification of all insurance benefit features; possible reclassification of some contracts as insurance versus investment only; identification of all annuitization options; determination of additional insurance benefit

liabilities; determination of annuitization liabilities; possible splitting of the current DAC balance into a sales inducement asset and a remaining DAC balance; and finally, determination of resultant impact on EGPs together with potential restatement of DAC and PVP (present value of future profits from acquisitions).

Q61. How are the initial insurance benefit and annuitization liabilities determined?

A61. Paragraph 41 of the SOP states that any adjustment in contract holder liabilities from adopting this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of Accounting Principles Board (APB), Opinion No. 20. In layman's terms, this means that a liability would usually be established at the adoption date of the SOP as if the SOP had been in existence since the inception of the contract and any change in balance sheet amounts would be reported separately in income as a change in accounting principle.

For the purposes of the initial insurance and annuitization reserves required by the SOP, the actuary would usually determine past assessments and paid benefits from the contract inception dates to date of accounting change. Likely, the historical data would not all be available and actuaries would therefore make good faith estimates of the required information. The benefit ratio and additional liabilities would then be determined by projecting future expected assessments and insurance or annuitization benefits, to add to the historical data.

Some actuaries have posed the possibility of basing the initial calculations only on those contracts in force as of the accounting change date. Specifically, past assessments and benefits would be considered only for those contracts currently in force. While there might be instances where this method is acceptable, it is generally felt that this approach would not usually comply with APB 20 requirements.

Q62. How are sales inducements usually handled for in-force business?

A62. The SOP is silent on transition rules for the accrual of a liability for sales inducements such as persistency bonuses. However, paragraph 36 of the SOP requires the accrual be *“over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if, earlier.”* Some actuaries interpret this as requiring a liability at adoption as applicable for the in-force. Accordingly, the actuary would normally determine the accrual for in-force business as per the SOP rules, i.e., going back to contract inception. Note that accrual under the SOP does not allow for assumption of persistency (though a liability is usually recorded as surrender charge revenue once a contract surrenders, so, a liability would be established only for those contracts in force as of the transition date).

Paragraph 42 of the SOP sets out explicit transition rules for the sales inducement asset created by the deferral of sales inducements where applicable. The value of the deferred sales inducement asset as of accounting change date is the asset, if any, currently held by the company. If past practice was to amortize the sales inducement asset in proportion to EGPs, the asset at adoption of the SOP could change as a result in modified historical and

prospective EGPs resulting from implementing other provisions of the SOP. If the deferred sales inducement asset was being amortized on a basis other than EGPs, no adjustment to the asset as of the adoption date is required or allowed by the SOP. In addition, the SOP would prohibit the actuary from retroactively establishing an asset if none currently exists. The starting sales inducement asset would be amortized based on EGPs similar to DAC, but on a prospective basis only. Future sales inducements on both inforce and new contracts would be deferred where applicable.

For companies that had not previously established an asset and a liability for persistency bonuses, the transition rules are inconsistent in that they suggest that only a liability be established at the adoption date of the SOP. For contracts inforce at adoption date, it would appear that sales inducements incurred post-adoption could be deferred where a sales deferral inducement asset were permitted. Sales inducements incurred are determined as bonuses credited plus accrued plus change in liability (see Q51 above). Some actuaries consequently believe it is appropriate to include the initial change in liability (i.e., establishment of the liability at transition), as an item of deferral in the persistency bonus asset.

Paragraph 42 of the SOP requires the sales inducement asset to be reported apart from DAC on the balance sheet. In the income statement, the change in deferred sales inducement asset would usually be included in policy benefits.

Q63. How are past acquisitions typically handled?

A63. The SOP is silent on this issue. However, the actuary might look to the guidance provided by the SOP for reinsurance (the acquisitions of blocks of business is sometimes accomplished through reinsurance). Reinsurance requires that liabilities be established as of the reinsurance date, and based on the reinsurance premiums.

Some actuaries believe that generally, for past acquisitions, additional insurance and annuitization benefit liabilities required by the SOP should start at zero as of purchase date since the purchase GAAP accounting implicitly included provisions for these benefits either in the fair value of the liabilities or the PVP calculation. After the purchase date, a liability would then develop from subsequent assessments collected and benefits paid. It should be noted that there would be an adjustment to the original amortization pattern for PVP to the extent the EGPs are changed under the SOP.

Q64. What is the required accounting change date, and what needs to be reported?

A64. The SOP is effective for financial statement for fiscal years beginning after December 15, 2003 for domestic companies, and one year later for foreign registrants. For most companies this means starting with first quarter 2004. For many companies, the SOP represents a material accounting change which would need disclosure in their year-end 2003 financials. The actuary might then be requested by the company to quantify as of year-end 2003 the impact of the SOP estimated for the first quarter 2004 implementation.

Early adoption is permitted, however, this must be as of the start of the reporting year and would thus require applying the new accounting basis for all reporting quarters of that year. For example, early adoption undertaken in the fourth quarter of 2003 would require the company to restate financials from the first through third quarters of 2003 on the new accounting basis. The actuary might then be requested by the company to quantify the impact of the SOP on past quarters of 2003.

Q65. For investment contracts that followed the FAS 91 interest method for DAC amortization prior to the adoption of the SOP, the SOP would require these contracts to be reclassified as universal life-type contracts if certain insurance features are determined or deemed to be significant under the provisions in the SOP. At the adoption of the SOP, how would this change typically be handled?

A65. In applying the principles to APB 20, the usual approach to account for this change in product classification would be to go back to the inception of the contract and calculate current GAAP balances as if the contract were classified as a universal life type contract from this issue date. Presumably, this would require DAC to be amortized in proportion to EGPs as required by FAS 97. Any differences in the DAC and benefit liabilities as of the adoption date would be reported as a change in accounting principles.

An argument could be made that to be consistent with the SOP guidance for sales inducements that were capitalized and amortized on a basis other than EGPs prior to the adoption of the SOP, the DAC balance at the adoption date could be maintained with future DAC amortization only based on EGPs.