EXPOSURE DRAFT

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

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

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Introduction

The practices presented here represent the views of actuaries in industry, consulting and public accounting firms who are involved in implementation of the SOP. The purpose of the practice note is to assist actuaries with application of the SOP. It should be recognized that the information contained in the practice note provides guidance, but is not a definitive statement as to what constitutes generally accepted practice in this area. Actuaries should consider the facts and circumstances specific to their situation, including the views of their independent auditors, in making a determination of appropriate practice.

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

- FAS 60 - *Accounting and Reporting by Insurance Enterprises*
- FAS 97 - *Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- FAS 113 - - *Accounting and Reporting for reinsurance of Short-Duration and Long-Duration Contracts*
- FAS 133 - *Accounting for Derivative Instruments and Hedging Activities*
- SOP 03-1 - A*ccounting and Reporting by Insurance Enterprises for Certain Nontraditional Long Duration Contracts and for Separate Accounts*
- EITF 92-9 - *Accounting for the present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*
- AICPA Technical Practice Aid 6300.09 - *Reinsurance*

This practice note has been divided into six sections:

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

As of the date this Practice Note was published, a number of SOP 05-1 implementation issues were being discussed by the AICPA's Insurance Expert Panel. At this time, the Expert Panel has not issued any additional clarifying guidance on these issues. Therefore, if and when the Expert Panel provides additional guidance, some comments in this Practice Note may need to be updated.

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

All Lines of Business

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

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

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

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

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

A3: Yes. This is addressed in paragraph A16 that states "A respondent to the November 2004 exposure draft requested that the SOP specifically address the accounting

implications when the contract is substantially changed and the value of business acquired (VOBA) is viewed as part of the contract holder liability. AcSEC noted that paragraphs 16 and 25 of this SOP provide guidance on accounting for other balances associated with the replaced contract." The net liability then falls under the SOP.

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

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

- The treaty is amended to include an additional block of inforce. The reinsurer determines the new block to be nonintegrated and establishes DAC for the new block. DAC for the existing block is retained.

- The ceding company sells its block of business and the treaty is novated to allow the acquiring company to be the new cedant. Other than the change in counterparty, the reinsurer may determine that the treaty terms to be substantially unchanged and DAC is retained.

- The treaty is amended to reduce the coinsurance percentage on inforce. The reinsurer determines there is a reduction in coverage with proportional reduction in premiums and allowances. DAC is retained and appropriately reduced.

- The treaty is amended to convert from coinsurance to yearly renewable term (YRT) and assets transferred to the ceding company. The reinsurer determines there is a substantial change in investment risk and the original treaty should be considered to have terminated and the DAC associated with that treaty should be accounted for as any termination would under the appropriate accounting model (e.g., FAS 60, FAS 97). The YRT treaty would be considered as if it were a new treaty and only acquisition expenses associated with this issuance of the new treaty are to be deferred.

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

A5: Yes. Paragraph A17 states, "AcSEC also concluded that while the criteria in this SOP may not be directly applicable to reinsurance contracts, based on the specific facts and circumstances of a transaction, the concepts are useful in evaluating the implications on deferred acquisition costs of modifications to reinsurance contracts or the underlying reinsured contracts." Some potential situations might include the following:

- The treaty covers YRT on a block of term and universal life (UL) for any excess of death benefit over a retention limit. The reinsurer establishes FAS60 DAC for the

YRT treaty. A policyholder converts from term to UL of the same face amount. The underlying policy conversion has no bearing on the amount of reinsurance assumed or the YRT reinsurance premiums. There has been no change to the reinsurance treaty. The reinsurer sees no need to look through to the underlying contract conversion and DAC is retained.

- The treaty covers coinsurance of a block of term and UL. The reinsurer establishes a DAC asset and amortizes it in accordance with FAS 60 for term and with FAS 97 for UL. A policyholder converts from term to UL of the same face amount. The reinsurer writes off a portion of the FAS 60 DAC related to termination of the term policy. The reinsurer does not transfer DAC to the treaty covering the converted UL policy to avoid mixing FAS 60 and FAS 97 accounting.

- The treaty covers coinsurance of a block of term. A policyholder exercises an option that results in a substantial change where this is done within the original contract and meets the test of paragraph 9 for exemption as an internal exchange. If the treaty contemplates this, i.e., allows for ongoing coinsurance of that contract as a matter of course, the reinsurer might conclude that no internal exchange occurred and DAC is maintained. As a practical matter, the reinsurer simply follows the accounting determination of the ceding company. However, if the treaty requires special consideration such as reinsurer re-underwriting or approval, or adjustment to the coinsurance terms, the reinsurer might conclude this was a substantial change and would then extinguish the DAC.

Q6: How is business ceded handled under the SOP?

A6: AICPA Technical Practice Aid (TPA) 6300.09 is in regard to SOP 03-1 but has general relevance for reinsurance accounting. The TPA states *"The accounting for reinsurance should be separate from the accounting for the direct contracts of the ceding company in accordance with paragraphs 14 through 16 of FASB Statement No. 113."* Accounting on a pre-reinsurance basis then directly follows the SOP.

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

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

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

When testing for "substantially changed" in these circumstances, note that if Affiliate B reunderwrites the new policy, there would be a presumption that the new contract is substantially changed. Paragraph A27 of the SOP provides that "Reunderwriting the entire contract generally would indicate a substantial change resulting from a change in the kind or degree of mortality, morbidity, or other insurance risk."

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

A8: Even though a block of policies may have no DAC or DAC-like items, it is advisable to consider application of SOP 05-1 because it could impact the accounting for subsequent activity on such a block. For example, there may be options or riders that can be elected by the policyholder in the future and generate acquisition costs that would be accounted for under the SOP.

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

Further, death benefits or annuitization benefits under SOP 03-1 may be currently so far out of the money as to produce zero reserves, or benefits paid to date may have exceeded the accrued liability, resulting in no current liability. But if future market conditions change, then non-zero SOP 03-1 liabilities may need to be established. The amount of such liabilities may depend on the original classification under SOP 05-1 of the replacement policy. In addition, the SOP guidance needs to be evaluated because, even in the absence of DAC balances, there exists the potential for an impact on recorded liability balances (e.g., GMDB, GMIB, unearned revenue, FAS 60 liabilities).

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

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

Q10: Is it possible to pass the requirements of paragraphs 9a, 9b and 9c but fail paragraph 9d?

A10: Several respondents to exposure drafts of the SOP felt that paragraph 9d is not an independent criterion for determining whether a modification is an internal replacement, but rather a consequence of the other criteria. Without publicly commenting on this point, AcSEC concluded that it was appropriate to retain the paragraph 9d criterion nonetheless. One interpretation would view paragraph 9d’s role as adding emphasis to the points established in paragraphs 9a, 9b, and 9c, rather than as an independent criterion. It provides an additional way of thinking about the criteria that may give a clearer route than any of the other three for determining that a contract modification is not an internal replacement. Under this view, it may not be possible to fail the requirements of paragraph 9d without failing at least one of the other three criteria as well.

A counterargument to this position is that a contract feature could exist from contract inception without any liability having been established for it. In such a situation, one could argue that the feature was not “accounted for” since contract inception, as required under paragraph 9d. Others, however, take a broader view of the term “accounted for” and take it to mean, “considered.” In this view, a contract feature would have been “accounted for” since contract inception, as long as it was considered in the establishment of the accounting policy when the contract was written. The example given in the SOP of a feature that escapes FAS 133 treatment because of the grandfathering provision of that Statement seems to support this view. Consequently, if this interpretation is accepted, then a feature that existed and was not "accounted for" at contract inception but otherwise passes the criteria of paragraphs 9a, 9b, and 9c would have been the subject of flawed accounting, because all contract features should have been considered in the establishment of accounting treatment at issue.

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

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

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

A12: Paragraph A4 states "… the accounting should be based on the substance of the transaction, regardless of whether it takes the form of an amendment, or rider to the contract or the issuance of a new contract in a contract exchange." Where modification to the contract terms is effected by a contract exchange, and could be an alternate to modifying the existing contract or adding a rider, the SOP requires these be treated as internal replacements. It is expected the company would, through its administrative and systems procedures, be able to identify substantially all policies that have been or are in the process of being exchanged. For example, there are statutory policyholder disclosures required for certain contract replacements, and certain tax preferential transfer procedures required (e.g., "1035" exchanges).

Q13: Certain reductions in benefits required by state law or regulation are not considered internal exchanges. Does this apply as well to other official directives such as court ordered modifications?

A13: Paragraph 10 of the SOP states that partial withdrawals, surrenders, or reductions in coverage are not internal replacements where these occur either by terms as of inception of the contract, or "if required by state law or regulation, at terms in effect when the reduction is made." The SOP appears to endorse the concept of substance over form, for example, stating in paragraph A4 that "the legal form of a modification should not determine the accounting applicable to the transaction and the accounting should be based on the substance of the transaction." It thus appears that other official directives, for example, federal versus state law, or state bulletin versus state regulation, could be

equally applied. Other official directives might include court ordered changes such as remedies to policyholders for market misconduct, or court ordered revised benefits under a structured settlement case, or state approval of a health plan rate increase where the company must provide the policyholder the option of paying either the higher premiums or unchanged premiums but with reduced benefits. It would appear important that in all these cases, "the terms in effect when the reduction is made" should be as set by the official directive and not by the company.

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

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

A14: This question is relevant only insofar as such a policy has been classified as a long-duration policy such that a material asset for deferred acquisition costs is maintained. One interpretation is that the revision of the benefits to comply with new regulation would not constitute a contract modification because of wording contained in paragraph 10. However, this sense is conveyed in a relatively narrow discussion in paragraph 10, which applies specifically to partial withdrawals, surrenders, and reductions in coverage. This could lead to a conclusion that the determinations made under the SOP are independent of the motivation, regulatory or otherwise, that gives rise to them, with the exception of reduced coverages addressed in paragraph 10. Yet another view is that, the relatively narrow applicability of paragraph 10 notwithstanding, changes motivated by regulatory requirements might not constitute internal replacements at all insofar as they can be analogized to guaranteed renewability and/or the implied right within any contract of the regulatory authority to alter its provisions in the interest of public policy. The company should determine if there existed a new negotiation between the company and the policyholder at the time of the change. If so, the transaction would constitute a termination of the old contract and the issuance of a new contract.

Annuity Business

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

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

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

In order to conclude that the internal replacement resulted in a substantially changed policy, consideration would likely be made as to whether the nature of the investment return rights had been changed as a result of the addition of the living benefit (paragraph 15.b). For a typical GMAB or GMWB that has been added to a variable annuity without such benefit previously, the conclusion that a substantial change has occurred would likely be supported. The examples in paragraphs B.39 to B.41 support this conclusion.

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

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

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

A17: Because existing GAAP guidance (e.g., FAS 60 and FAS 97) already requires that an annuitization be treated as a new contract, the SOP would not impact existing accounting.

Individual Health Business

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

A18: So long as the guaranteed renewability feature is clearly established within the contract, a rate increase across an entire class of policyholders does not constitute a contract modification and, consequently, is not an internal replacement subject to the guidance of the SOP.

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

A19: The SOP appears to ignore the legal form taken by the action (See Q1) and looks to the underlying nature of the insurer-policyholder relationship. Thus the answer to this question depends upon the facts and circumstances of the situation. However, the issuance of a new contract as part of a benefit enhancement does not *per se* result in the extinguishment of the original contract in the context of the SOP.

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

A20: As long as the option to receive reduced benefits in exchange for keeping premiums level is provided for in the original contract, election of this option does not constitute a contract modification and the action would not be deemed an internal replacement subject to the provisions of the SOP. If a contractual provision is not present, then the transaction may be deemed an internal replacement. However, paragraph 15c states that a reduction in benefit or coverage does not necessarily mean that a replacement contract is substantially changed, provided that the premium is reduced by an amount commensurate with the reduction in coverage. It is ordinarily prudent to review paragraphs B.21 and B.22 of the SOP in these situations.

Group Business

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

A21: The SOP applies to all contracts accounted for under FAS 60 and FAS 97 and therefore does apply to group business. In some circumstances the provisions of the SOP would be applied at group contract level and in other circumstances the provisions of the SOP would be applied at the individual certificate level. According to paragraph A.29 of the SOP, "the evaluation of all the related facts and circumstances of a group contract is required to determine whether a contract should be analyzed at the group contract level or individual certificate (under the group contract) level for purposes of applying the guidance in this SOP."

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

A22: For group long duration guaranteed renewable business, rate increases as allowed under the terms of the contract would not meet the definition of a modification under paragraph 8 of the SOP as long as the rate increase was applied to an entire class of group policyholders and there was no discretion used by the insurance company to adjust the rate for a specific contract. This is consistent with the discussion in paragraph A.25 of the SOP regarding changes in COI rates for universal life type contracts. Similarly,

changes to premium rates, which are based on a formula specified in the contract and do not involve insurer discretion, would not be considered a modification under the SOP.

Premium or benefit changes that involve a judgmental review of the actual experience of the contract holder or the renegotiation of rates or benefits with the contract holder, even if no reunderwriting has occurred, generally would be considered a modification that is subject to the guidance in SOP 05-1.

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

All Lines of Business

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

A23: For long-duration contracts, the SOP defines integrated contract features as those for which the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the base contract, and nonintegrated contract features are those for which the determination of benefits provided by the feature is not related to or dependent on the account value or other contract holder balances of the base contract. For many benefit features, these definitions can be clearly applied. However, some transactions may include benefit features that could possibly fit both definitions, while other transactions do not appear to meet either definition. The SOP goes on to say that underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the base contract. It is also typical that nonintegrated benefit features are accounted and/or reserved for separately. Using this information, many actuaries believe that for those transactions where integrated/nonintegrated is not clear, the intent of the SOP is that if there is not separate pricing or reserving of a benefit feature in these situations, it should be considered an integrated benefit feature. If it is not clear whether a particular modification is either integrated or nonintegrated, it should be treated as if it were integrated, which would require analysis under paragraph 15 of the SOP. This is consistent with the flow chart in Appendix C of the SOP.

Q24: What are some examples of integrated and nonintegrated benefit features?

A24: The most common examples of integrated benefit features are the minimum guaranteed benefits attached to variable annuity contracts, such as guaranteed minimum death benefits and guaranteed minimum withdrawal benefits. Waiver of premium for UL policies, where the benefit is current charges that include cost of insurance charges as opposed to waiving a target premium, is another example of an integrated benefit feature.

Nonintegrated benefit features are more numerous. These would include accidental death benefits, term riders, LTC riders and other types of waiver of premium not included in

the integrated benefit examples above.

Q25: Paragraph 11 of the SOP defines nonintegrated contract features as "those for which the determination of benefits provided by the feature is not related to or dependent on the account balance or *other contract holder balances* of the base contract." (emphasis added). What are some examples of "other contract holder balances" that could affect the classification of integrated benefits versus nonintegrated benefits under paragraph 11 of the SOP?

A25: Depending on the structure of the policies in question, "other contract holder balances" might include the face amount, cash value or death benefit available in the contract. Under some circumstances, the ongoing premium amount specified in the contract would be considered an "other contract holder balance" under the SOP. Whether or not such premiums are considered to be "other contract holder balances" would determine whether the addition of a disability waiver of premium rider would be integrated or not. If premiums are fixed in the contract, then it is not likely that adding a benefit based on this fixed schedule would be considered to be integrated.

The initial premium amount could also potentially be an "other contract holder balance" under certain policy designs where reference is made to the initial deposit for defining certain policy benefits (like minimum return guarantees). The initial deposit may be an "other contract holder balance" even if the ongoing premium is not considered an "other contract holder balance." That is because the initial deposit would have defined the initial account balance in the contract. Whether or not the initial deposit is considered an "other contract holder balance" would determine whether addition of a benefit that depends on the initial deposit to the contract would be integrated or not. Similar to the above example, if a benefit is added that is based on a fixed amount, even if that amount was originally at the discretion of the policyholder, then it is not likely that this would be considered to be integrated.

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

A26: Typically, the addition of a feature on a long-term care or other health insurance contract would not be integrated with the main contract. Therefore, the original contract could be accounted for as previously, with the new feature accounted for independently as a benefit for which no recurring premium is charged. The fact that the new benefit and the existing benefit are predicated on the occurrence of the same insured event does not imply *per se* that the benefit features are integrated. If, however, the benefit is considered to be integrated**,** it would need to be evaluated under paragraph 15. Of course, each situation would have to be reviewed in light of its particular facts and circumstances by consideration of the items listed in paragraph 15.

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

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

Section C: Determining substantial changes issues as per paragraph 15

All Lines of Business

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

A28: Paragraph 15b does not mention degree or significance of the change in investment return rights. Therefore, a literal reading of the SOP might suggest that no such assessment of degree is necessary with respect to investment return rights. This view holds that certain actions, like the addition of a minimum interest rate guarantee, fundamentally changes the nature of the investment reward rights and therefore should be viewed as a substantial change to the contract without reference to the implied economic value of the change. Paragraph A.30 contains language that might support this view. However, some might argue that the “nature” of investment return rights is only truly changed to the extent that a material, quantifiable change in the value of those rights has occurred. Others believe that if AcSEC intended a significant component to be part of the requirements of paragraph 15b, that paragraph would have contained a more specific requirement for that test.

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

A29: There are six criteria that must be satisfied for a contract to be considered “substantially unchanged,” as outlined in paragraph 15 of the SOP. Paragraph 15b states that the nature of the investment return rights must not have changed. One potential argument under this criterion is that the *nature* of the investment return rights does not change when one guaranteed minimum interest rate is replaced by another, even though

the materiality of the guarantee is different. This line of reasoning may lead to a conclusion that the contract is substantially unchanged. A different reading of the term "nature," as contemplated in paragraph 15b and discussed in paragraph A.30 of the SOP, is that a change in guaranteed rate needs to be evaluated in order to determine the likelihood of the guarantee coming into play in future crediting rates. If the likelihood that the change in minimum guaranteed rates would significantly affect future crediting rates is remote, then such a modification would not be a substantial change. If the change in minimum crediting rates is likely to affect future crediting rates, then some actuaries believe that the contract now credits interest based on a formula (at least under a material number of potential scenarios), so the nature of the guarantee has changed and the requirements of paragraph 15b are not met.

UL/VUL Business

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

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

One interpretation is that the replacement of an Option A contract with an Option B contract is an internal replacement under the SOP (unless the provisions of paragraph 9 are met), is an integrated benefit under the SOP, and would be analogous to a face increase. Thus, they believe that this would not constitute a substantial change if "only the additional face amount has been underwritten during the contract amendment" and if "the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained," as outlined in paragraph B.8.

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

Annuity Business

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

A31: There are six criteria that must be satisfied for a contract to be considered "substantially unchanged," as outlined in paragraph 15 of the SOP. One of those states that if there is a reduction in benefit, there must be a corresponding reduction in premiums. Otherwise, the change in coverage could result in a substantially changed contract. Also, if the dropping of a rider is considered to "change the nature of investment return rights and rewards", the contract could be considered substantially changed even if there is a corresponding reduction in premiums. Note that if the ability to drop the rider is provided within the original terms of the contract, then the policyholder's election to do so would not constitute an internal replacement transaction, rendering the determination of "substantially changed" vs. "substantially unchanged" irrelevant.

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

A32: There are six criteria that must be satisfied for a contract to remain "substantially unchanged," as outlined in paragraph 15 of the SOP. One of those states that the nature of the investment return rights must not have changed. Some actuaries believe that a change in the underlying guaranteed rate, assuming it is a material change, would result in a substantial change. The comments in Q28 above apply. As described more fully in the answer to Q40 below, re-initiation of the surrender charge period by itself does not result in a substantially changed contract under paragraph 15 of the SOP.

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

A33: There are six criteria that must be satisfied for a contract to remain "substantially unchanged," as outlined in paragraph 15 of the SOP. One of those states that the nature of the investment return rights must not have changed. One view is that a change from a GMWB to a GMAB is a change in the nature of the investment return rights, and therefore would result in the contract modification being considered a substantial change. Another view is that, because both the GMWB and the GMAB guarantee a minimum return on the account value over a period of time, the nature of the investment return rights has not materially changed and therefore the modification does not constitute a substantial change. A third view similar to this is that as long as the benefits are not significantly different, as measured by actuarial costs or benefit ratios or other appropriate measures, then this type of modification is not a substantial change. The SOP provides an example, which states that replacement of a roll-up GMDB with a ratchet GMDB may not be considered a substantial contract modification. By analogy, one may assume that it is possible to conceive of the replacement of one living benefit guarantee with another under a variable annuity contract as not constituting a substantial change. However, because GMDBs (covered under paragraph 15a) include an element of mortality risk, whereas GMABs and GMWBs (covered under paragraph 15b) typically involve no mortality risk, it ordinarily would not be prudent to extensively rely upon the analogy between GMDBs and these latter two living benefit guarantees.

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

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

Individual Health Business

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

A35: Please refer to Q20/A20 in this document regarding benefit reductions in lieu of a rate increase. For benefit increases, a determination must be made whether or not such change is within a narrow range allowed under the original contract provisions. If so, then the change in benefits does not constitute a contract modification and the action is not an internal replacement subject to the SOP. On the other hand, if the modification is outside of the range contemplated within the original contract, then the modification would have to be assessed to determine (a) whether it is integrated or nonintegrated with the original contract and (b) if integrated, whether the contract is substantially changed. For individual health policies, one might expect the feature to be nonintegrated because health policies typically do not have benefit features that are a function of contract holder balances. However, each situation would have to be assessed individually depending on the particular facts and circumstances.

Group Business

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

A36: See Q22/A22 regarding when a rate increase on a group guaranteed renewable long duration is considered a modification under the SOP. For a premium change on a group long duration contract that is considered to be a modification under the SOP, a

determination must be made as to whether the repricing/rate reset mechanism under the contract constitutes “reunderwriting” as contemplated in paragraph 15a. While many believe that the judgmental review of actual experience is a renegotiation of the contract and essentially includes all of the aspects of reunderwriting, the determination of whether "reunderwriting" has occurred has to rely on the specific facts and circumstances of the transaction.

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

All Lines of Business

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

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

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

Section E: Other issues

All Lines of Business

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

A38: Paragraph 25 of the SOP states that "Other balances associated with the replaced contract, such as any liability for GMDB or GMIBs, should be…accounted for based on an extinguishment of the replaced contract and issuance of a new contract." The liability would be released even if the replacement contract were to provide a benefit of higher value than the contract being replaced. This could lead to unusual results. Assume for example a situation where an insurance company has a block of annuity policies on its books that include a GMIB. Assume the GMIB is well in-the-money, and that there is little DAC associated with this block of business. And assume the company decides to make some modification to the annuities (perhaps adding some small benefit at no charge) that meets the criteria within the SOP for a "substantially changed internal replacement." It appears that the valuation actuary may be required to write off the large GMIB reserve associated with the in-the-money GMIB, even though the company's exposure has not decreased (it may have actually increased if an additional benefit was added). And, because there is little DAC associated with the block, the asset write off associated with accounting for the exchange will be much smaller than the liability write off, thus inflating income.

It is possible that situations may arise where a literal following of the rules in response to certain product actions may generate counter-intuitive results. Examples may include a situation where a product area makes a unilateral change to a block of universal life contracts for the sole purpose of achieving a DAC write off, or where they make a unilateral change to a block of health insurance contract for the sole purpose of achieving a write off of the FAS 60 reserve. Others believe that the SOP is in the spirit of a "principles" rather than "rules-based" approach and its application requires the use of judgment. Under this view, a trivial change made solely to purportedly achieve an accounting result is unlikely to have the impact indicated.

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

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

A39: Paragraph 25 of the SOP states "an internal replacement that is deemed to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract..." Many actuaries interpret this paragraph to require that the reserve on a FAS 60 contract that is substantially changed be written off (along with the DAC and other balances associated with the

contract). A new reserve would need to start being accrued based on the characteristics of the new contract, as if that contract was newly issued.

In some instances this can lead to surprising results. In the case of an annually renewable term policy, there is little or no prefunding of the reserve. Thus the reserve on a newly issued contract is not likely to be very different from the reserve on the replaced contract. Similarly, in the case of a contract (such as non-par whole life) where a significant cash value is carried over from the replaced contract to the replacement contract, the reserve on each would likely be heavily influenced by the cash value amount, so that the reserves would not likely be very different. However, on a contract with prefunding but no cash value (such as many long term care contracts, disability income contracts or level term contracts) the replaced contract would likely have a significant reserve while the replacement contract would restart accruing the reserve from zero. Although this result may seem surprising – especially if the original contract is being continued with just some modification that qualified for a substantial change – this reserve release appears to be the correct application of the SOP. Of course, the requirements of FAS 60 related to loss recognition in the face of a premium deficiency still apply.

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

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

A40: The impact of expected future activity on lapse assumptions should be reflected in estimated gross profits (EGPs). For example, if it is expected that there will be future modifications to the policy that will be treated as substantially changed internal replacements, the lapse assumption used to project EGPs should reflect that expected activity.

Section F: Examples

All Lines of Business

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

A41: Merely restarting or revising the terms of the surrender charge, without impacting the account balance of the new or revised contract, would not appear by itself to be a substantial change. Because the account balance has not been reduced, this does not breach the provisions of paragraph 15d of the SOP. The revision or restarting of the surrender charge only affects the cash surrender value, not the account balance. As long

as there is an account balance, changes that only impact the cash surrender value do not affect whether or not a substantial change occurred.

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

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

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

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

Traditional Life Business

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

A44: The SOP provides that reunderwriting an entire contract "generally would indicate a substantial change resulting from a change in the kind or degree of mortality, morbidity, or other insurance risk" (paragraph A.27). In determining whether changing a policy status between smoker and non-smoker constitutes "reunderwriting" in this context, considerations might include: (1) if the company only uses information specific to the use of tobacco in determining whether they will permit the change from smoker to non-smoker, (2) if there is no judgment required on the part of the underwriter, (3) if there have been no fundamental changes in the pricing of both smoker and non-smoker rates at the time of the change.

Q45: Re-entry term

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

Q46: Term to par WL

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

Q47: Term to non-par WL

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

Q48: Extended maturity rider

A48: Adding an extended maturity rider causes the period for which a contract is subject to mortality risk to lengthen. For example, the original contract may have endowed at age 95, while after adding the rider the endowment age is 110. Thus, the insurance company is subject to an additional 15 years of mortality risk for the contract. Paragraph 15a of the SOP requires that for an exchange to be considered substantially unchanged "the insured event, risk, period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality, morbidity or other insurance

risk, if any". In the case of an extended maturity rider, it is clear that the "period of coverage" has changed. However, whether the change is "significant" is subject to interpretation. Paragraph A.27 of the SOP provides further guidance. In particular, "AcSEC noted that, in determining whether a change in the degree or kind of risks in a contract is significant, the focus should be on the substance of the risks of the contract, and not on the form of the contract. Factors to consider in determining whether there are significant changes in insurance risk may include changes in actuarially determined estimated costs for that benefit or the SOP 03-1 benefit ratio related to that benefit feature." Thus, if the actuarial present value of the expected mortality costs during the extended coverage period is small, the addition of an extended maturity rider may be considered a substantially unchanged internal replacement. Whether the actuarial present value should be measured prospectively only, or from the original issue date, is currently being discussed by the AICPA's Insurance Expert Panel.

Q49: Increasing death benefit coverage on a traditional life contract

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

- A contract may include an option to purchase additional insurance (OPA) rider. This gives the contract holder the right to purchase additional insurance coverage with no additional underwriting. The additional premium is commensurate with the additional insurance coverage obtained. As per paragraph B.3, exercise of the option to purchase additional coverage under the OPA rider is "an example of a nonintegrated contract feature. Once purchased, the benefit under the OPA rider generally is accounted for as a separate contract".

- A contract holder may obtain a second life insurance policy for an incremental face amount, with underwriting on the new policy only and no change to the original contract. As per paragraph B.5 of the SOP, "this transaction does not fall within the definition of an internal replacement in paragraph 8 of this SOP. The accounting for the original contract remains unchanged and the new contract is accounted for independently of the original contract. Any deferrable acquisition costs associated with the new contract are deferred and amortized according to the revenue or margin stream of the new contract, as applicable".

- The original contract could be modified by amendment or rider to increase the face amount. As per paragraph B.6 of the SOP, this "is considered a nonintegrated benefit feature that should be accounted for separately from the existing life insurance contract, provided that the additional premium…is not in excess of an amount commensurate with the incremental insurance coverage and does not result in the explicit or implicit reunderwriting or repricing of other components of the contract."

Q50: Nonforfeiture benefits

A50: Elections by whole life policyholders to exercise nonforfeiture benefits, such as reduced paid up insurance or extended term insurance, would generally not be considered internal replacements. Paragraph 10 of the SOP states that "reductions in coverage, as allowed by terms that are fixed and specified at contract inception either in the contract or other information available to the contract holder…are not internal replacements subject to this guidance, as long as there are no reunderwriting or other modifications to the contract, at that time…" However, if the nonforfeiture benefit involves some modification other than a reduction of face amount or term of insurance, such as a change to participation features or dividend rights, the nonforfeiture benefit may need to be considered an internal replacement subject to the guidance of the SOP. If the policy is accounted for under FAS 60, the election of a nonforfeiture option that is non premium paying would result in a DAC writeoff because DAC amortization occurs in proportion to premium revenue.

Q51: Reinstatement of a policy

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

UL/VUL Business

Q52: Increase in face amount

A52: Paragraph B.8 of the SOP concludes that a face increase on a universal life-type contract is not a substantial change if "only the additional face amount has been underwritten during the contract amendment" and if "the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained." Thus the typical universal life face amount increase would not constitute a substantial change, and the DAC would be continued. If, however, there was underwriting of the face amount of the original contract during the contract amendment, or if the charge for the increased face amount was in excess of an amount commensurate with the increased death benefit, this would be a substantially changed internal replacement, and DAC would be written off. Paragraph B.8 of the SOP only considers face amount increases on Option A death benefit plans. Some actuaries believe that face amount increases to Option B contracts are nonintegrated and should be accounted for separately.

A reduction in face amount would likely be considered a "reduction in coverage" under paragraph 10 of the SOP. Thus, they would not constitute internal replacements subject

to the guidance of the SOP, so long as the modification was "allowed by terms that were fixed and specified at contract inception…"

Q53: Universal life to universal life with a no-lapse guarantee

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

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

Q54: Universal life to universal life with second-to-die feature

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

Annuity Business

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

A55: Most actuaries believe that for such a contract, that does not involve any additional fee upon reset and the reset feature was accounted for from contract inception, the election would not be a replacement, because the requirements of paragraph 9 of the SOP would be satisfied. However, many actuaries also agree that if the fee charged to the policyholder changes on reset, the election would result in an internal replacement, because paragraph 9c states that the contract is exempted only if the insurance enterprise cannot "adjust the pricing of the benefit, feature, right, or coverage." In this situation, which clearly involves an integrated benefit feature, the change will need to be evaluated under paragraph 15. Under paragraph 15b, there are two views. One view says that,

because the nature has not changed, paragraph 15b is satisfied. The other view is that one needs to examine the significance of the change to determine if paragraph 15b is satisfied. In addition, it is usually prudent for the provisions of paragraph 15c of the SOP regarding additional charges to be considered.

Q56: Variable annuity to fixed annuity

A56: Paragraph B.31 of the SOP describes the situation where a fixed-rate GIC is exchanged for a variable-rate GIC. This is described as a significantly changed internal replacement because "the investment return rights…are different between the two contracts." This treatment is required when a fixed annuity is replaced by a variable annuity or vice versa. This would be the case whether or not the variable annuity that is part of the exchange includes a fixed rate option, because the ability to move the account balance into variable funds in itself represents a significant change to the investment rights.

Q57: Single premium deferred annuity to market value adjusted annuity

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

Q58: Single premium deferred annuity to equity-indexed annuity

A58: Paragraphs B.26 and B.27 of the SOP describe the situation where an SPDA is exchanged for an equity indexed annuity (EIA). This is described as a substantially changed internal replacement because "the nature of the contract holder's investment return rights differs significantly between the two contracts. The crediting rate of the SPDA contract is declared at the discretion of the insurance enterprise, while the crediting rate of the EIA is contractually determined by reference to a pool of assets, an index or other specified formula."

Q59: Single premium deferred annuity to multi-bucket annuity

A59: Paragraphs B.28 and B.29 of the SOP describe the situation where an SPDA is exchanged for a multi-bucket annuity. This is described as a substantially changed

internal replacement because “the nature of the investment return rights are different between the two contracts.”

Q60: Deletion of GMIB/GMAB/GMWB

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

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

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

Q61: Return of premium GMDB to ratchet or rollup GMDB

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

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

Other actuaries believe that the example in the SOP is inconclusive, and may not apply to all situations. These actuaries also look to the example of a face increase on a UL contract as described in paragraph B.8 of the SOP. Paragraph B.8 concludes that a face increase on a universal life-type contract is not a substantial change if there is no underwriting other than for the additional face amount and if “the additional premium

charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained." Because variable annuities with GMDBs are generally classified as "universal life-type contracts", these actuaries believe that in determining whether a ratchet GMDB to a ratchet rollup GMDB is a substantial change they must also look at whether the increased charge for the richer death benefit is commensurate with the increased benefit. If the charge is in excess of an amount commensurate with the increased benefit, these actuaries believe there is a substantial change in the degree of mortality risk. Otherwise, they believe that there is no change to the degree of mortality risk.

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

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

Individual Health Business

Q62: Replacement of an individual health insurance policy with a newly upgraded policy.

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

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

- Is the change in features achieved through the issuance of a new contract? Though the SOP appears to make it clear (paragraph A.4) that the technical structure of a contract modification is not relevant *per se* to a conclusion as to the classification of a contract modification, such structure (e.g., where the modification was accomplished through the issuance of a new contract) could provide an indication of the nature of the modification (e.g., the fact that a new contract was issued rather than a rider added to an existing

contract may indicate that the newly added feature is integrated with the existing contract).

- Was the change accompanied by a change in premium? Without a change in premium, the change may be an indication that the insured risks have not materially changed, such that the contract is substantially unchanged.

- Was the change contemplated under the original terms of the contract? If so, then the modification may not be a contract replacement, provided that the change is within a narrow range allowed within the contract.

- Does the contract provide additional benefits for an added fee while leaving existing benefits unchanged? In such a case, the additional benefits and any associated premium may be interpreted to be a new contract (and accounted for as such) with the existing benefits and original premiums not considered to be an internal replacement.

Group Business

Q63: Adding a new member to a group insurance policy

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