

Statutory Issue Paper No. 89

Separate Accounts

STATUS

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Original SSAP and Current Authoritative Guidance: SSAP No. 56

Type of Issue:

Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance for separate accounts is addressed in Chapter 25, Separate Accounts, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). General reserve requirements and accounting for all life and annuity contracts with life contingencies has been established in *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51). Current statutory accounting for separate accounts varies by state.
2. GAAP guidance for separate account contracts requires investments to be reported at market value except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets are generally reported in accordance with *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), as amended by *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan* (FAS 114), *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) and *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of* (FAS 121). GAAP guidance for separate account contracts requires policy reserves or liabilities to be established using the balance that accrues to the benefit of the policyholder.
3. The purpose of this issue paper is to provide guidance on accounting and reporting for separate accounts in both the general account and separate account statement, consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Introduction

4. Separate accounts are used to fund variable life insurance, variable annuities, modified guaranteed annuities and modified guaranteed life insurance, or various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options.
5. Assets held in separate accounts are owned by the insurer. All investment income and realized and unrealized capital gains and losses from assets allocated to a separate account, net of related investment expenses, are generally reflected in the separate account and, except for modified guaranteed annuities, modified guaranteed life insurance, and separate accounts established and filed to provide guaranteed benefits, investment performance is generally not guaranteed by the insurer. Charges relating to contract guarantees, administration, and investment management are deducted from separate accounts.

General Account Reporting

6. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account and shall be accounted for as transactions of the general account.

7. For those separate account contracts classified as life contracts under *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*, premiums and annuity considerations shall be recorded as income in the Summary of Operations of the general account, and as transfers to premiums and considerations in the separate account statement. Deposit-type contracts shall be recorded in the general account in accordance with *Issue Paper No. 52—Deposit-Type Contracts*. Charges (e.g., fees associated with investment management, administration, and contract guarantees) assessed on the separate accounts, as well as the net gain from operations of the separate account shall be recorded as income in the Summary of Operations of the general account. Expenses relating to investment management, administration, and contract guarantees pertaining to separate account operations, as well as benefits and surrenders incurred on behalf of separate account contracts classified as life contracts, net transfers between separate accounts, commissions, and premium taxes (if any) shall be recorded as expenses in the Summary of Operations of the general account.

8. The general account shall include the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated. Changes in the surplus of the separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, shall be charged or credited directly to the unassigned funds (surplus) of the general account.

9. Where a variable annuity contract or variable life insurance contract contains a guaranteed minimum death benefit, any reserve liability for such death benefit provision shall be recorded and held in the general account based on the reserving guidance in paragraphs 24 and 25. Any differences between the benefit paid and the separate account asset value of the contract shall be charged against or credited to the general account in its net gain from operations.

10. Separate account surplus may not become negative. For example, for separate account contracts which have annuitized (i.e., contracts in the payout stage), lower than expected mortality on variable annuity contracts containing mortality guarantees may cause a deficiency in the investment funds underlying the contract reserves. Thus the general account incurs an expense and the separate account realizes revenue to cover this deficiency, if necessary. Conversely, excess funds from higher than expected mortality will result in mortality gains that are included in the Summary of Operations of the separate account and are ultimately recorded as equity in net income from separate account operations as discussed in paragraph 7.

11. For variable products, separate account surplus created through the use of the commissioners' reserve valuation method (CRVM), commissioners' annuity reserve valuation method (CARVM), or other reserving methods, shall be reported by the general account as an unsettled transfer from the separate account. The net change on such transfers shall be included as a part of the net gain from operations in the general account.

12. Surplus funds transferred from the general account to the separate account, commonly referred to as seed money, and earnings accumulated thereon shall be reported as surplus in the separate accounts until transferred or repatriated to the general account. The transfer of such funds between the separate account and the general account shall be reported as surplus contributed or withdrawn during the year.

13. If an Asset Valuation Reserve (AVR) is required for investments held by separate accounts, it is combined with the general account AVR and accounted for in the general account financial statements (see *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (Issue Paper No. 7)). The criteria for determining when an AVR is required for separate accounts are described in paragraph 17 of this issue paper.

Separate Account Reporting

14. The separate accounts annual statement is concerned with the flow of funds related to investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account. As a result, the separate account statement shall report only the assets, liabilities, and operations of the separate account and shall not include general account expenses related to investment management, administration, or contract guarantees pertaining to separate account operations which are recorded in the general account.

15. The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes) and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized and unrealized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations. When the contract provides for such, expenses and taxes associated with the separate account investment operations shall be deducted in the determination of net investment income. Deposits and withdrawals on deposit-type contracts shall be recorded in the Summary of Operations. Benefits and surrenders, reserve transfers, policy loans, policyholder charges (e.g., fees associated with investment management, administration, and contract guarantees), and federal income taxes relating to the separate account are recorded as expense transfers to the general account in the Summary of Operations. The net change in aggregate reserves relating to separate account contracts is reported as an expense in the Summary of Operations.

16. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at market value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

Separate Account AVR and IMR Reporting

17. An AVR is generally required for separate accounts when the insurer, rather than the policyholder/contractholder, suffers the loss in the event of asset default or market value loss. An AVR is required unless:

- a. The asset default or market value risk is borne directly by the policyholders, or
- b. The regulatory authority for such separate accounts already explicitly provides for a reserve for asset default risk, where such reserves are essentially equivalent to the AVR.

18. Assets supporting traditional variable annuities and variable life insurance generally do not require an AVR because the policyholders/contractholders bear the risk of change in the value of the assets. However, an AVR is required for that portion of the assets representing the insurer's equity interest in the investments of the separate account (e.g., seed money).

19. Assets supporting typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset loss.

20. Certain separate accounts are also required to maintain an Interest Maintenance Reserve (IMR). The IMR requirements for investments held in separate accounts are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

21. An IMR is required for separate accounts with assets recorded at book value, but is not required for separate accounts with assets recorded at market value. For example, separate accounts for traditional variable annuities or variable life insurance do not require an IMR because assets and liabilities are valued at market value.

22. If an IMR is required for investments held by separate accounts, it is kept separate from the general account IMR and accounted for in the separate accounts statement.

23. The AVR and IMR shall be calculated and reported in accordance with the Annual Statement Instructions.

Policy Reserves

24. Statutory policy reserves shall be established for all contractual obligations of the insurer arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

25. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendix A-250, A-270, A-255, A-585, A-588, A-620, A-820 A-822, and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market.) Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

Other Liabilities

26. The separate account shall accrue as a liability, subject to contractual provisions, amounts payable, including, but not limited to:

- Charges for investment management, administration, and contract guarantees
- Investment expenses
- Investment taxes, licenses, and fees (Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate account but may be transferred to the general account for payment)
- Federal income taxes
- Unearned investment income
- Net transfer due to (from) the general account
- Remittances and items not allocated
- Payable for investments purchased
- Net adjustments in assets and liabilities due to foreign exchange rates

Seed Money

27. When a new separate account is initiated, the insurer may make a temporary transfer of surplus funds commonly referred to as seed money to the separate account. Such funds and earnings accumulated thereon shall be reported as surplus in the separate accounts statement until transferred or repatriated to the general account. The transfer of such funds to and from the separate account shall be reported as surplus contributed or withdrawn during the year.

Disclosures

28. The general account financial statement shall include a description of the general nature and characteristics of the various kinds of separate accounts business conducted by the company and included in the company's Separate Accounts Statement. For each grouping (as detailed in paragraph 29), the following shall be disclosed:

- a. Premiums, considerations or deposits received during the year;
 - b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at market value separately from those whose assets are carried at amortized cost/book value;
 - c. Reserves by withdrawal characteristics, i.e., whether or not the separate account is subject to discretionary withdrawal or market value adjustment, or to withdrawal at book value with or without surrender charge;
 - d. Reserves for asset default risk, as described in paragraph 15.b., that are recorded in lieu of AVR.
29. Separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):
- a. Separate Accounts with Guarantees:
 - i. Indexed separate accounts, which are invested to mirror an established index which is the basis of the guarantee;
 - ii. Nonindexed separate accounts, with reserve interest rate at no greater than 4% and/or fund long-term interest guarantee in excess of a year that does not exceed 4%;
 - iii. Nonindexed separate accounts, with reserve interest rate at greater than 4% and/or fund long-term interest guarantee in excess of a year that exceeds 4%.
 - b. Nonguaranteed Separate Accounts—Variable separate accounts, where the benefit is determined by the performance and/or market value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.
30. Provide a reconciliation of the amount reported as transfers to and from separate accounts in the Summary of Operations of the separate accounts statement and the amount reported as net transfers to or from separate accounts in the Summary of Operations of the general accounts statement.

DISCUSSION

Statutory Guidance

31. Consistent with Issue Paper No. 7, this issue paper adopts current statutory guidance for AVR and IMR for Life and Accident and Health insurance companies.

32. The statutory accounting principles outlined in the conclusion above regarding accounting and reporting for separate account life and annuity contracts are consistent with current statutory accounting, except for separate account deposit-type contracts which shall be accounted for consistent with the guidance in *Issue Paper No. 52—Deposit-Type Contracts*. The statutory accounting principles outlined in the conclusion above are consistent with the Statement of Concepts which states:

Conservatism

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

Consistency

The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Recognition

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

GAAP Guidance

33. In Issue Paper No. 7, *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*, *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50), and *Issue Paper No. 51—Life Contracts*, the GAAP guidance (principally, FAS 60, *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, FAS 115, *FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, and *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises*) related to insurance contracts and separate account assets and liabilities was rejected for the reasons set forth therein.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- This issue paper references the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. The guidance for AVR/IMR was subsequently moved to the Annual Statement Instructions for Life and Accident and Health Insurance Companies. SSAP No. 56 references the Annual Statement Instructions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)**Statutory Accounting**

34. The Life/A&H Accounting Practices and Procedures Manual, Chapter 25, Separate Accounts, provides the following guidance with respect to separate accounts:

SEPARATE ACCOUNTS

A life insurance company is authorized by state statutes to establish separate accounts and to allocate thereto, pursuant to agreements, amounts paid to it. Separate accounts may be used:

1. to provide for annuities, whether ultimately payable in guaranteed fixed amounts or variable amounts or both;
2. to provide life insurance where the benefits, premiums, or both, are payable on a variable basis and for which the reserves vary according to the investment experience of the underlying separate account;
3. to accumulate funds which are intended to be applied at some later time to provide life insurance, whether fixed or variable or both; or
4. to accumulate, or hold in a separate account, proceeds applied under settlement or dividend options.

All investment income and capital gains and losses (whether or not realized) from assets allocated to a separate account are, in accordance with applicable agreements, credited to or charged against the separate account policyholders. Investment performance is generally not guaranteed by the insurance company.

Assets allocated to separate accounts are owned by the insurer and the insurer is not a trustee by reason of the separate accounts. However, if permitted or required by state law, a separate agreement may provide that the portion of the assets of the separate account equal to the

reserves and other contract liabilities of the separate account shall not be chargeable with liabilities arising out of any other business of the insurer.

State statutes generally provide that amounts allocated to a separate account and accumulations on those amounts may be invested and reinvested without regard to any requirements or limitations imposed upon an insurer by the investment statutes which apply to insurers generally.

Some statutes provide that to the extent that the insurer's reserve liability, with regard to benefits guaranteed as to dollar amounts and duration and funds guaranteed as to principle amount or stated rate of interest, is maintained in a separate account, a portion of the assets of the account at least equal to the reserve liability with regard to these benefits shall be invested in accordance with the investment statutes of the domiciliary state. These assets shall be reported separately and valued in accordance with the rules otherwise applicable to the insurer generally.

Assets allocated to a separate account, other than those provided for guaranteed benefits as described above, are valued at their market value on the date of valuation, or if there is no readily available market, then in accordance with the applicable contract.

The reserve or liability under a contract with a separate account provision is usually determined on the basis of the market value of the assets in the separate account.

Separate accounts may be used to fund individual variable life insurance, individual variable annuities, group variable life insurance, group variable annuities and various group contracts under pension or other employee benefit plans where funds are held in a separate account essentially as a liability. The financial experience on these separate accounts is reported in the annual statement of separate accounts business.

Relationships of the Separate Accounts Annual Statement and the Life and Accident and Health Annual Statement

Accounting for separate account business involves both the general account of a company and the separate accounts. The separate accounts annual statement is concerned primarily with the investment activities of the separate accounts and with the flow of funds from and to the general account. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account fund and are accounted for as transactions of the general account; the expenses incurred on account of these functions are reported in the life and accident and health annual statement. Thus, premiums and considerations and benefit payments on separate accounts business are reported respectively in the premiums and annuity considerations exhibit and the policy contract claims exhibit of the life and accident and health statement. Similarly the policy exhibit and the exhibit of annuities and supplementary contracts with life contingencies in the life and accident and health statement includes variable annuity contracts.

Expenses incurred on contracts with separate accounts (other than direct investment expenses) are generally reported in the general account. Fees related to these expenses are charged to the separate accounts policyholders. Federal income taxes and taxes incurred on separate account investments are reported in the separate account statement, but other taxes, i.e., taxes on consideration, are reported in the general account. Where a variable annuity contract contains a guaranteed minimum benefit such as return of consideration paid on death within a specified period, any excess of the benefit paid over the separate account asset value of the contract would customarily be a charge against the general account. Any reserve liability for such death benefit provisions is normally carried in the general account.

Under a variable annuity contract containing mortality guarantees which are reserved in the general account, when lighter than expected mortality causes a deficiency in the investment funds underlying the contract reserves, the general account must transfer funds to the separate account. Conversely, excess funds from higher than expected mortality are transferred to the

general account. As a general rule, the total statement value of the assets held in a separate account must be equal to (never less than) the total separate account reserve liability of the contracts participating in the separate account. If mortality gains are allowed to accumulate in the separate account, these accumulations may be reported as surplus.

Overview of the Flow of Funds and Accounting

Gross purchase payments received are reported in the life and accident and health statement. In the case of a variable life or variable annuity contract, the net purchase payment is transferred immediately to the separate account. In most cases, the purchase payment transferred will be net (gross minus loading).

If a net purchase payment on a variable annuity is not accounted for as consideration received, it should be transferred to the separate account as an “annuity deposit” or “purchase payment reserve” (or similar term). The loading might be treated as a consideration for accounting purposes. At such time as the accumulation is to be applied to purchase an annuity or supplementary contract, the entire accumulation (net purchase payments plus investment income) is transferred to the general account to be accounted for as consideration received. Appropriate taxes on the total amount of such consideration (including all accumulated investment income) are deducted before the remaining funds are either transferred back to the separate account as consideration for a variable annuity or supplementary contract or used to buy a fixed annuity or supplementary contract in the general account. The return of the fund or surrender or death prior to maturity is generally reported as a return of purchase payments. This is the equivalent of the redemption by the issuer of shares in a mutual fund, which a variable annuity in the accumulation stage closely resembles.

In the employee benefit area, separate accounts may be used to fund part or all of unallocated pension funds during the accumulation phase and group variable annuities in the payout phase. Amounts of consideration or purchase payments are received from the employer through the general account and transferred to the separate account after deducting any loading for expenses, etc. Funds withdrawn for the purchase of fixed or variable annuities are transferred to the general account where they are reported as considerations received. Applicable taxes are deducted prior to purchase of an annuity for a retiring employee.

Under certain arrangements, employee benefit funds may be put into a separate account to be accumulated until withdrawn to be used for various purposes. Such funds would not be reported as income; amounts transferred from the general account are reported net of amount returned.

Generally, considerations, purchase payments, deposits, etc., received by a separate account are recorded on a cash basis.

Life and annuity benefits and payments on supplementary contracts are paid through the general account with funds transferred from the separate account. The liability for any benefits transferred but unpaid at year-end would be carried by the general account.

Some variable annuity contracts, during the accumulation period, permit the contract holder to transfer funds between the separate account and the general account. In order to avoid inflating the income reported in either or both accounts, special provision is made for transferring these reserves between the general account and the separate accounts.

Individual variable annuity contracts usually contain guarantees for mortality and expense assumptions. Charges for these guarantees, and for administrative and investment management expenses, are usually expressed as an annual percentage of the asset value of the contract and may also include an amount per contract. Such charges may be calculated and deducted from the separate account on a daily, weekly, or monthly basis—generally the same interval at which the separate account is valued. Group contracts with separate account provisions may have similar arrangements.

Charges, when deducted from the separate account asset values, are usually transferred to the general account. Charges deducted but not yet transferred are usually carried as a liability in the separate accounts statement. Some companies prefer to accumulate the mortality and expense guarantee charges in the separate account as surplus.

Investment expenses incurred may be payable directly by the separate accounts or may be incurred by the general account to be reimbursed by the separate accounts. Investment expenses incurred by the general account on behalf of the separate accounts may be reported in the life and accident and health statement. These investment expenses may be deducted from this statement, on a line by line basis, and entered in the same way in the separate accounts statement; or they may be deducted as a single negative item in the life and accident and health statement and entered as a summary item in the separate accounts statement.

Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate accounts but may be transferred to the general account for payment. Federal income taxes are not paid directly by the separate accounts. The amount of federal income tax estimated as incurred is transferred to the general account.

A reserve for future federal income taxes is provided for in the separate accounts statement. The purpose of this item is to recognize that the amount of capital gains credited to contract holders at any time is the net after deducting capital gains taxes which would be payable under the assumption that all assets were disposed of at that point in time. This deduction is reflected in the increase in the liability item, "Reserves for future federal income taxes." Note that a decrease in unrealized capital gains would cause a decrease in this reserve.

When a new separate account is initiated, the company may make a temporary transfer of surplus funds commonly referred to as "seed money" to the separate account. Such funds are reported as surplus in the separate accounts statement and the transfer of such funds to and from the separate account would be reported as surplus contributed or withdrawn during the year. The rules and regulations of various states restrict the sale, exchange, or transfer of assets between the general and separate accounts.

Separate accounts, as reported in the statement blank, would normally not develop a gain from operations because (a) gains or losses arising from mortality and expenses are reflected in the general account; (b) investment expenses and taxes are deducted from investment gains and losses; and (c) investment gains and losses after expenses and taxes are absorbed in the increase in reserve liabilities. A gain from operations could arise from earnings on contributed surplus maintained in a separate account or when a company does not transfer mortality and expense guarantee charges out of the separate accounts. Note that a separate account surplus can never be permitted to become negative.

Mortality gains and losses can be handled in either of two ways.

1. If the separate accounts are being reported on a zero gain from operations basis, then any net gain from mortality should be transferred to the general account, or, if a loss, a transfer of an offset amount should be made from the general account. In either case, on the aggregate write-in lines under "Other transfers from the separate accounts" in the Summary of Operations page of the separate accounts statement, appropriately captioned, e.g., "Other transfers (net)," may be used. An offset to a mortality loss would be a negative entry.
2. If mortality gains or losses are to be permitted to flow through to the gain from operations and the surplus account is to be kept at zero, then a counterbalancing entry must appear in the surplus account. Since surplus in a separate account cannot be permitted to be negative, a counterbalancing contribution to surplus from the general account must be made whenever surplus would otherwise become negative.

The analysis of increase in reserves illustrates how the year-end reserves reported are developed from the operations of the separate account. It follows in a general way the corresponding analysis in the life and accident and health statement.

Separate Account Reporting in the Life and Accident and Health Statement

Transfer transactions affect both the life and accident and health and the separate accounts statements but to avoid duplicate detailed reporting, and also to avoid complicating the life and accident and health statement, the details of the transfer are shown only in the separate accounts statement. Aggregate transfer items are netted and shown in the inserts on the liabilities page and in the Reconciliation of Cash and Invested Assets in the separate accounts statement. These same net totals would be included as single line entries on appropriate pages of the life and accident and health statement.

The asset page of the life and accident and health statement provides for the entry of the totals from the asset page of the separate accounts statements. The liabilities page of the life and accident and health statement provides for two entries from the separate accounts statements. The first entry shows the amount of transfers to the separate accounts due or accrued. This item is entered on a net basis so that if there is an amount due from the separate accounts to the general accounts, the net of the two will be entered as a negative item. The reason for this treatment is that a more normal treatment, under which an amount due the general account from the separate account is entered as an asset in the life and accident and health statement, would inflate both the assets and the liabilities totals of the life and accident and health annual statement. The second entry on the liabilities page of the life and accident and health statement is for the total liabilities entry from the separate accounts statement.

The Summary of Operations and Analysis of Operations by Lines of Business of the life statement provide for entry of net transfers to separate accounts--there is no one source for this figure in the separate accounts statement. Items relating to separate accounts may also appear as direct entries to surplus.

35. The Separate Accounts Annual Statement Blank Instructions provide the following guidance with respect to separate accounts:

GENERAL

The instructions for completing the general account are to be followed to the extent applicable. This supplement provides additional instructions that are unique to the Separate Accounts Blank as well as some that differ from those for the Life and Accident and Health Blank. Where there is a conflict with the Life Blank's instructions use these instructions. The reporting date must be plainly written or stamped at the top of all pages, exhibits and schedules (and duplicate schedules) and also upon all inserted schedules and loose sheets.

The separate accounts statement reports only the operations of the separate accounts themselves. It assumes that the administration of the contracts is reflected in the general account statement--hence, administrative expense does not appear in the Separate Accounts Statement, premiums and considerations are net of loading, and the expenses and taxes are those associated with the separate account investment operations.

Receipts other than income from investments are handled as a transfer from the general account. Similarly, amounts providing for the payment of benefits, including surrender benefits and various other payments, appear as transfers from the separate account to the general account. When eventually paid, these items are reported in the general account statement. The assets and liabilities are strictly those which arise from the operations of the separate accounts themselves, i.e., policy and contract reserves and items related to the making of investments, including investment expenses and taxes due or accrued. Unpaid transfers due the general account, such as surplus, contractual benefits, or contractual charges, would also appear on the liability page.

36. The June 5, 1995 minutes of the Separate Accounts Working Group of the Accounting Practices and Procedures (EX4) Task Force provide the following guidance with respect to separate accounts:

1. Accounting for Separate Account Surplus

Peter Storms (Arthur Andersen) provided a summary of the work accomplished to date relative to accounting for separate account surplus. Mr. Storms noted that the interested parties group continues to support its original recommendation.

Tomoko Stock (Calif.) stated that California opposes the recommendation of the interested parties group. Specifically, they oppose the reporting of fee income, generated through the use of Commissioners Annuity Reserve Valuation Method (CARVM), being allowed to flow through the general account's income statement on an accrual basis. Ms. Stock suggested that this treatment of fee income inflates current income and has a potential impact on stockholder dividends. The California position is to recognize the income as it is realized.

Jack Gies (Conn.) noted that surplus created through the use of CARVM is a book item, not a cash item. He also noted that the income earned from separate account fees is fairly certain to be realized either through mortality and expense charges or through surrender charges.

Working group members noted that the accounting treatment being proposed assumes that CARVM is being applied in an accurate and prudent manner.

Alan Close (Northwestern Mutual Life) stated that his recommendation included a different balance sheet presentation from that recommended by the interested parties group, with an approach that stresses the appropriate measure of assets and liabilities. He noted, however, that his recommendation supported the income statement presentation recommended by the interested parties group.

Bill Carroll (American Council of Life Insurance—ACLI) noted that the ACLI's committee on statutory accounting met in May 1995 and voted to support the recommendation of the interested parties.

After being duly moved and seconded, the working group voted to adopt the accounting treatment for separate account surplus which requires that separate account surplus created through the use of CARVM be recorded as an unsettled transfer from the separate accounts; that separate account seed money and earnings accumulated thereon, be reported in the separate accounts until repatriated; and that the net gain from separate accounts operations be included in the general account summary of operations. Blank proposals to effect this accounting treatment will be prepared for submission prior to July 1, 1995.

Ms. Stock noted that the adopted accounting treatment will include parenthetical entries on the balance sheet to specifically identify amounts in the transfer account that are related to the use of CARVM.

The working group noted, that in adopting this accounting treatment, it will be necessary for the Risk-Based Capital Task Force to revise the life risk-based capital report to include the separate accounts transfer balance with the separate accounts surplus when applying the risk-based capital charge. Blaine Shepherd (Minn.) stated that he would report this issue to the Risk-Based Capital Task Force.

37. Chapter 16, *Asset Valuation Reserve and Interest Maintenance Reserve*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies states the instructions for calculating the AVR and IMR are contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies.

38. Section 6. *Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains the following excerpts (note that this is not quoted in its entirety):

This Section applies to all life insurance companies and fraternal benefit societies. The Section describes in general terms, principles of the calculation for Interest Maintenance Reserve (IMR) for realized gains and losses from fixed income investments and the Asset Valuation Reserve (AVR) on all invested assets held by a company. [Refer to the NAIC's Life and Health Annual Statement Instructions for specific reporting guidance.] The IMR is a single component reserve. The AVR breaks down into two major components and each component has two subcomponents:

The Default Component--

- (i) Other Than Mortgage Subcomponent
- (ii) The Mortgage Subcomponent

The Equity Component--

- (i) The Common Stock Subcomponent
- (ii) The Real Estate and Other Invested Assets Subcomponent

(A) Interest Maintenance Reserve (IMR). This reserve applies to realized capital gains and losses net of tax on short-term and long-term fixed income investments. These gains and losses are from the disposal of investments as reported in Schedule D, Part 4 for long-term bonds and preferred stock; Schedule DA, short-term bonds; Schedule DB, interest rate hedges; Schedule B, mortgage loans; or Schedule BA for other fixed income investments. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.

The current year's IMR is equal to:

The beginning balance
plus (minus) the realized capital gains (losses) net of tax attributed to interest rate changes
plus (minus) realized liability gains (losses) net of tax attributed to interest rate changes
less an amortization amount

(a) Interest Related Realized Capital Gains and Losses:

The gains and losses are to be reported net of applicable capital gains taxes allocated in accordance with an insurers established policy.

A realized gain or loss on each debt security and mortgage backed security will be an interest related gain or loss if the debt security's beginning NAIC rating did not change by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. With respect to Class One Bond Mutual Funds, "realized capital gains and (losses)" include any capital gains and losses realized by the Company, whether from sale of the Fund or capital gains distributions by the Fund. However, where the gain on a convertible bond or preferred stock sold while "in the money" is included in IMR, the expected maturity date is defined as the next conversion date. "In the money" is defined to mean that the number of shares available currently or at next conversion date, multiplied by their current market price, is greater than the statement value of the convertible asset. However, for a convertible bond or convertible preferred stock purchased while its conversion value exceeds its

par value, any gain or loss realized from its sale before conversion must be excluded from the IMR and included in the AVR. Conversion value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock's current market price. The holding period is defined as the period from the date of purchase to the date of sale. For end of period classification, the most recent available rating should be used. For debt securities acquired before January 1, 1991, the debt security's rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security's gain or loss should not be included in this reserve if the debt security rating was ever a "6" during the holding period.

Preferred stock that did not have an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6" or "P-4", "P-5" or "P-6" at any time during the holding period should be reported as interest related gains and (losses) in the Interest Maintenance Reserve if the stock's beginning NAIC/SVO rating did not change by more than one classification at the end of the holding period.

For preferred stocks acquired before January 1, 1993, the holding period is assumed to have begun in December 31, 1992.

For Class One Bond Mutual Funds, the holding period is defined as one calendar year to expected maturity.

Determination of IMR gain or loss on multiple lots of the same securities should follow the underlying accounting treatment in determining the gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss.

Losses recognized on loan-backed bonds and other structured securities that have a negative effective yield at the date of valuation should be treated as realized losses and included in the reserve as if the security had been sold and the loss considered an interest rate loss. If the security is valued using the prospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of anticipated future cash flows of the security is less than the current book value of the security at the date of valuation. If the security is valued using the retrospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of actual and anticipated cash flows is less than the original cost of the investment.

Capital gains and losses net of capital gains tax on mortgage loans, where interest is not more than 90 days past due, not in process of foreclosure, not in course of voluntary conveyance, or have not had restructured terms over the prior two years will be classified as an interest rate gain or loss. Prepayment penalties recorded as capital gains on mortgage securities are also considered to be due to interest rate changes.

Realized gains and losses on fixed income investments recorded on Schedule BA should be classified as an interest gain or loss if they are in the nature of those defined for bonds, preferred stocks and mortgages.

Realized gains and losses, net of capital gains tax, on derivative investments arising out of transactions entered into solely for the purpose of altering the interest rate characteristics of the company's assets and/or liabilities should be allocated to the IMR and amortized into income over the remaining life of the assets or liabilities associated with the derivative instruments. Gains or (losses) on dollar repurchase agreements that are traded for the fee have no IMR (or AVR) impact because they are treated as financings.

If during the course of the year, the SVO removes the classification of "class one" from a Class One Bond Mutual Fund, the company shall not report capital gains or (losses) on this schedule. Any such removal of the "class one" classification will cause the Fund to be reported as common stock on the applicable schedules.

(b) Liability gains/(losses) Subject to IMR Amortization

1) Reinsurance -

The interest rate related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR and then amortized into income provided:

1. the portion of the block reinsured represents more than 5% of a company's general account liabilities (Page 3, Line 26 of the Annual Statement),
2. the transaction is irrevocable and is to a non-affiliate and
3. the transaction was completed in the current year.

A company may elect to use a lower materiality threshold than the 5% specified in Item 1 above provided that such election is applied consistently to all transactions subsequent to the election, and the election is conveyed to the Insurance Department of the state of domicile. Once a threshold is elected, it can only be changed with the prior approval of the Insurance Department of the state of domicile.

The amount of the gain or loss that is interest rate related and its IMR amortization should be determined using the following procedure for the portion of the block sold, transferred or reinsured.

1. Identify the IMR balance and future amortization arising from the past and present dispositions of the assets associated with the block of liabilities.
2. Identify the IMR balance and future amortization that would result if the remaining assets associated with the block of liabilities were to be sold.
3. Define the interest rate related gain or (loss) net of taxes to be the negative of the sum of the IMR balances determined in steps 1 and 2. The future amortization of the gain or loss is the negative of the sum of the amortization determined in steps 1 and 2.

The associated assets are the assets allocable to the reinsured block of business for the purposes of investment income allocation. If the company has not been tracking the investment income of the block, it should retrospectively identify the assets using procedures consistent with its usual investment income allocation procedures. The associated assets are not necessarily the same as the assets transferred as part of the transaction.

2.) Market Value Adjustments

Material gains or losses resulting from market value adjustments on policies and contracts backed by assets that are valued at book, including the marginal tax impact, should be captured by the IMR and amortized in a manner consistent with the determination of the market value adjustment. A gain or loss is considered material if it is in excess of both .01% of liabilities and \$1,000,000. The amortization schedules should be determined in a manner consistent with the determination of associated market value adjustment.

(d) Amortization into income:

There are two acceptable methods for accumulating and calculating the amortization schedule. A company can select either the seriatim method or the grouped method for calculating IMR amortization. Although a company is not precluded from changing methods on a prospective

basis, the overriding consideration is the reasonableness of the amortization. However, once a method is selected for a particular year's capital gains, the amortization is locked in and cannot be changed (at least not without the specific approval of the commissioner).

1. **Serialim Method**--The amount of each capital gain or (loss), net of capital gains tax, amortized in a given year using the serialim method is the excess of the amount of income that would have been reported in that year, had the asset not been disposed of, over the amount of income that would have been reported had the asset been repurchased at its sale price. The capital gains tax associated with or allocated to each gain or (loss) should be amortized in proportion to the amortization of the gain or (loss).

For loan-backed bonds and structured securities that are valued using currently anticipated prepayments use an amortization schedule developed using the anticipated future cash flows of the security sold consistent with the prepayment assumptions that would have been used to value the security had the security been purchased at its sale price.

The serialim calculation on an asset by asset basis is the desired approach, but since a serialim approach may impose an administrative burden on some companies, each company may use the method employed by that company to amortize interest related capital gains and losses among lines of business and policyholders in accordance with the investment income allocation process as approved by the state insurance department.

2. **Grouped Method**-- A company may use a standard "simplified method" by which the capital gains and (losses), net of capital gains tax, are grouped according to the number of calendar years to expected maturity.

The groupings are based on the years to expected maturity as of the date of sale.

- 0 calendar years to expected maturity,
- 1 calendar year to expected maturity,
- 2 to 5 calendar years to expected maturity,
- 6 to 10 calendar years to expected maturity,
- 11 to 15 calendar years to expected maturity,
- 16 to 20 calendar years to expected maturity,
- 21 to 25 calendar years to expected maturity,
- over 25 calendar years to expected maturity.

The amortization schedule for the current year is the sum of the gains and losses by maturity groupings times the appropriate factor for the current and future years. The maturity groupings and factors are found in 6(B)(j).

The presence of sinking fund payments, amortization schedules, expected prepayments, and adjustable interest rates complicate the determination of the number of calendar years to expected maturity. The expected maturity date is:

For fixed income instruments with fixed contractual repayment dates and amounts (including bonds, preferred stock, callable or convertible bonds and preferreds), the expected maturity is defined as the contractual retirement date that produces the lowest amortization value for Annual Statement purposes (lowest internal rate of return or "yield to worst"). Potential retirement dates include all possible call dates, and the contractual maturity date where a convertible bond or convertible preferred stock is sold while its conversion value exceeds its statement value and the gain is included in IMR, the expected maturity date is defined as the next conversion date. Conversion value is defined to mean the number of shares of common stock available currently or at the next conversion date, multiplied by the stock's current market price. When the instrument's contractual terms include scheduled sinking fund payments of fixed amounts, an additional calculation of yield to average life should be

included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, where the exercise option rests with the investor, expected maturity is the put or maturity date that produces the highest internal rate of return. For Class One Bond Mutual Funds, use one calendar year to expected maturity. For perpetual instruments, the expected maturity is 30 years from the current date.

However, where a callable bond purchased at a premium is called or sold after the expected maturity date, there should be no amortization of the call premium or interest rate related gain or loss and the gain or loss should be taken into income immediately. Similarly there should be no amortization of any interest rate related gain or loss arising if a convertible bond or preferred stock is disposed of after the expected maturity date.

For liability gains and losses included in the IMR, amortization should be determined in a manner consistent with the determination of associated market value adjustment or assets transferred.

“Calendar years to expected maturity” means the calendar year of expected maturity minus the calendar year of sale date.

For purposes of the grouped method, the following additional assumptions are applicable:

- For fixed income investments, other than residential mortgages and residential mortgage pass-throughs, without a maturity date or sinking fund schedule, a maturity date 30 years from the current year should be used.
- For loan-backed bonds and other structured securities that are valued using currently anticipated prepayments use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the security been repurchased at its sale price.

(e) Separate Accounts

Interest Maintenance Reserve (IMR) requirements for investments reported in the separate accounts statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in the separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book, but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the separate accounts statement, it is kept separate from the general accounts IMR and accounted for in the separate accounts statement. For further details see rules as explained in Sec (6) (A) (f).

(f) Negative IMR

A negative IMR balance may be recorded as a negative liability in either the general account or the separate accounts statements of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.

The following information is presented to assist in determining the proper accounting:

General Account <u>IMR Balance</u>	Separate Accounting <u>IMR Balance</u>	Net <u>IMR Balance</u>
Positive	Positive	Positive (See rule a)
Negative	Negative	Negative (See rule b)
Positive	Negative	Positive (See rule c)
Positive	Negative	Negative (See rule d)
Negative	Positive	Positive (See rule e)
Negative	Positive	Negative (See rule f)

Rules:

- a) If both balances are positive, then report each as a liability in its respective statement.
- b) If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement. If there is any disallowed negative IMR balance in the general account statement, record the disallowed portion as a positive amount for Disallowed IMR in a write-in line for assets not admitted in Exhibit 14. If there is any disallowed negative IMR balance in the separate accounts statement, determine the change in the disallowed portion and make a direct charge or credit to the surplus account for the Change in Disallowed IMR.
- c) If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the separate accounts statement.
- d) If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the separate accounts statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the separate accounts statement.
- e) If the general account balance is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the general account statement.
- f) If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the general account statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the general account statement.

(B) Asset Valuation Reserve (AVR). This reserve shall apply to the specific risk characteristics of all the invested asset categories excluding cash, policy loans, premium notes, collateral loans and income receivables. The specific assets to be included in each subcomponent are:

The Default Component

The Other Than Mortgage Loans Component shall include all fixed income investments that are corporate or governmental unit obligations, excepting those listed in subsection (g) as exempt from the AVR reserve, preferred stock and loan backed securities as reported in Schedule D - Part 1 and Part 2 -- Section 1, and Schedule DA, and counterparty exposure arising from derivative transactions as reported in Schedule DB - Part E - Section 1.

The Mortgage Loans Subcomponent shall include all farm, commercial, residential mortgages as reported in Schedule B and Schedule DA.

The Equity Component

The Common Stock Subcomponent shall include all affiliated and unaffiliated common stock investments as reported in Schedule D, Part 2--Section 2.

The Real Estate and Other Invested Asset Subcomponent shall include all real estate reported on Schedule A and all Other Invested Assets as reported on Schedule BA and DA.

(a) Calculation of the AVR:

The current year's AVR by subcomponent is equal to:

The beginning balance
 plus (minus) the realized capital gains (losses) net of tax as allocated by the company on assets corresponding to the subcomponent
 plus (minus) unrealized capital gains (losses) on assets corresponding to the subcomponent
 plus (minus) transfers between components
 plus an annual contribution
 plus any voluntary contribution
 plus (minus) an adjustment up to zero or down to maximum.

(b) Realized Capital Gains and Losses:

Report all realized credit-related (default) and equity capital gains and (losses), net of capital gains tax applicable to the assets in each component and subcomponent including those realized capital gains and (losses) that are incurred on Separate Accounts assets for which AVR treatment is required. Exclude all interest rate related capital gains and (losses) from the AVR.

A realized gain or loss on a debt security will be a credit related gain or loss if the debt security's beginning NAIC/SVO rating changed by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991 the debt securities rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security gain or loss should always be included in this reserve if the bond rating was ever a "6" during the holding period. Determination of the AVR gain or loss on multiple lots of the same fixed income securities should follow the underlying accounting treatment in determining gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss. Permanent impairment write-downs are treated as credit-related (losses).

Preferred stock that had an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6", "P-4", "P-5" or "P-6" at any time during the holding period shall be reported as credit related gains and (losses) in the Asset Valuation Reserve.

However, for a convertible bond or preferred stock purchased while its conversion value exceeds its par value, any gain or loss realized from its sale before conversion must be included in the Equity Component of the AVR. Conversion Value is defined to mean the number of share available currently or at next conversion date, multiplied by the stock's current market price.

For preferred stocks acquired before January 1, 1993 the holding period is presumed to have begun on December 31, 1992.

In addition, all gains or losses, net of capital gains taxes, on mortgage loans, where interest is more than 90 days past due, in the process of foreclosure in course of voluntary conveyance, or have had restructured terms over the prior two years, would be classified as credit related gains or losses. Permanent impairment writedowns are also treated as credit losses.

Realized gains or losses net of capital gains tax on portfolio or general hedging instruments should be included with the hedged assets. Gains or losses net of capital gains tax on hedges used as specific hedges should be included only if the specific hedged asset is sold or disposed.

Realized gains or losses on derivative instruments not accounted for as specific (as opposed to general) hedge transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments used in the general hedge.

Realized gains or losses, net of capital gains resulting from the sale of U.S. Government Securities and the direct or guaranteed securities of agencies which are backed by the full faith and credit of the U.S. Government are exempt from the AVR. This category is detailed in Section 6(B)(g)(i).

The gains or (losses) are to be reported net of applicable capital gains taxes as allocated by the company.

(c) Unrealized Capital Gains and Losses:

Unrealized gains and losses should be summarized by subcomponent asset type and included in the reserve computation including those unrealized capital gains and (losses) that are incurred on Separate Account assets for which AVR treatment is required. The equity method of accounting is allowed in accounting for the operating results of subsidiary, controlled or affiliated companies. If the equity accounting method is used, the amount of the undistributed income or loss reported in Exhibit 2 of the Annual Statement less the amount of any dividends received is to be included as an unrealized capital gain or loss when computing the Common Stock Subcomponent. Unrealized gains and (losses) for Affiliated Life Insurance Companies which are maintaining their own AVR are excluded since the maximum reserve factor for such companies is 0%.

Unrealized gains or losses on hedging instruments should be included with the hedged instruments.

(d) Transfers Between Components:

If the sum of a subcomponent's beginning balance, realized gains and losses and unrealized gains and losses is greater than the ending maximum of the subcomponent, and the balance of its sister subcomponent is below its maximum reserve, the excess must be transferred to the other subcomponent of the Default or Equity components up to that subcomponent's maximum.

If after the above transfers, the Equity or Default component is greater than total maximum for the component, the excess may be transferred to the other component or may be released to surplus.

If the balance before transfers of any of the four sub-components is negative, and the balance before transfers of its "sister" subcomponent within the same component is positive, the negative amount should be transferred to the "sister" sub-component to the extent that the transfer does not reduce the positive balance before transfers of the "sister" sub-component to less than 50% of its balance prior to the transfer.

No other transfers may be made without Commissioner approval. No transfers between the AVR and IMR are allowed.

(e) Annual Contribution:

The formula for the annual contribution to a subcomponent is as follows:

The contribution rate times the difference between the subcomponent maximum amount and the accumulated balance. (Accumulated balance is shown on Page 49, Line 6 of the Annual Statement). This number will be positive when the maximum reserve exceeds the accumulated balance and negative when the accumulated balance is in excess of the maximum reserve.

(f) Contribution Rate:

The contribution rate is 20% per year.

(h) Voluntary Contribution to the Reserves:

Companies may make voluntary contributions to the subcomponents. Voluntary contributions will become a permanent part of the AVR once they have been reported and may not be removed in subsequent years.

39. The NAIC Annual Statement Instructions provide the following guidance (note that this is not quoted in its entirety):

INTEREST MAINTENANCE RESERVE

Interest Maintenance Reserve (IMR) requirements for investments reported in the Separate Accounts Statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the Separate Accounts Statement, it is kept separate from the General Account IMR and accounted for in the Separate Accounts Statement.

ASSET VALUATION RESERVE

Asset Valuation Reserve (AVR) requirements for investments reported in the Separate Accounts Statement are applied on an account by account basis. If an AVR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an AVR is not required for a separate account, none of the investments in that separate account are subject to the requirement (except to the extent that such investments represent the company's capital and surplus interest in those investments).

Whether or not an AVR is required for separate account assets depends primarily on whether the insurer or policyholder/contractholder suffers the loss in the event of asset default or market value loss. An important exception to this is when specific state regulation provides an alternative to the AVR.

An AVR is required for separate account investments unless:

1. The asset default or market value risk is essentially borne directly by the policyholders, or
2. The regulatory authority for such separate accounts already explicitly provides for establishment of a reserve for asset default risk where such reserves are essentially equivalent to the AVR.

For example, assets supporting traditional variable annuities, and variable life insurance do not require an AVR because the policyholders/contractholders bear the risk of change in the value of assets. However, an AVR is required for that portion representing the company's equity interest in the investments of such a separate account, (seed money interest, for example). Assets supporting typical modified guaranteed contracts or market value adjusted contracts do require an AVR because the company is responsible for credit related asset loss. Another category of contracts requiring an AVR is contracts with book value guarantees similar to contracts generally found in the general account.

An example of the exception referred to in (2) above are contracts with market value separate accounts funding guaranteed benefits where state regulation provides alternatives to the AVR.

The following criteria are presented to assist in determining when an AVR or an IMR are required for investments in the Separate Accounts Statement:

Assets	Liabilities	Does Co. Suffer Asset Loss?	If Yes, Any Other Provision?	AVR*	IMR	Example Product
Market	Market	No	--	No	No	Variable Annuity
Market	Market**	Yes	No	Yes	No	Modified Gtd. Annuity
Market	Market	Yes	Yes	No***	No	MV S/A funding Gtd. Benefits
Book	Book	No	--	No	No	--
Book	Book	Yes	No	Yes	Yes	GIC in S/A
Book	Book	Yes	Yes	No***	Yes	--

* However, an AVR is required for that portion representing the company's equity interest in the investments of such a separate account.

** But not less than adjusted cash surrender value.

*** You must establish an AVR reserve unless there is a statutory requirement for the equivalent of an AVR reserve for such products.

If an AVR is required for investments in the Separate Accounts Statement, it is combined with the General Account AVR and accounted for in the General Account Statement. Worksheets supporting the separate accounts portion of the reserve are included in the Separate Accounts Statement.

When the AVR Default Component covers assets valued at market, use one of the following two methods (applied consistently by separate account) to determine when a gain or loss (net of capital gains tax) is credited or charged to the AVR:

1. A gain or (loss) is recorded as for the general account rules, i.e., upon sale of an asset which has changed more than one rating category or upon asset default. Once an asset is in default, all subsequent market value changes are reflected in the AVR, or
2. A similar procedure to Method 1 above is followed but, additionally, a gain or (loss) is recorded whenever an asset held changes by more than one rating category. As there might be more than one such event for a particular asset, e.g., a two rating downgrade followed by subsequent sale of the asset, the amount charged the AVR is net of any prior amounts charged for that asset.

When an AVR is required for the company's equity or capital and surplus interest in the investments of a particular separate account that does not otherwise require an AVR, the AVR requirement is based on the company's equity interest as of the statement date, expressed as a percent of total assets of the particular separate account. Once the equity interest percentage has been determined, it is applied to the realized and unrealized capital gains and losses and the investments of that particular separate account to determine the amounts to be included in the separate accounts data used for development of the current AVR. If the company's equity interest in all such separate accounts is less than 1/10th of 1% of the company's total admitted assets, the equity interest in the investments of such separate accounts is exempt from AVR requirements.

40. Most state regulations refer to the literature of the NAIC for guidance on the calculation of AVR and IMR. An example is the Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*, which states:

(4) Asset valuation reserve (AVR) -- A reserve applied to the specific risk characteristics of all the invested asset categories except cash, policy loans, premium notes, collateral loans, and income receivables. Asset valuation reserves shall be calculated as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

(12) Interest maintenance reserve (IMR) -- A reserve applied to realized capital gains and losses on short-term and long-term fixed investments. These gains and losses are from the disposal of investments as reported in Schedule D, part 1 -- Bonds, or Schedule B -- Mortgage Loans of the current annual statement. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

Generally Accepted Accounting Principles

41. FAS 60 provides the following guidance related to separate accounts:

Separate Accounts

53. Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or variable annuity contracts, pension plans, and

similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.

54. Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.

The reporting requirements of FAS 60, paragraphs 45-51, have been amended by *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, FAS 97, FAS 114, FAS 115, and FAS 121.

42. AVR and IMR are not addressed in current GAAP literature.

43. Paragraph 28 of FAS 97, as amended by FAS 115, addresses the GAAP accounting for realized gains and losses. It states:

Reporting of Realized Investment Gains and Losses of Investments

28. Statement 60 required that insurance enterprises report realized gains and losses in the statement of earnings below operating earnings and net of applicable income taxes. This Statement precludes that practice. Realized gains and losses shall be reported in the statement of earnings as a component of other income, on a pretax basis, and shall not be deferred to future periods either directly or indirectly. The first sentence of paragraph 50 of Statement 60 is superseded by the following: Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

OTHER SOURCES OF INFORMATION

44. The draft discussion material from previous Life Codification projects contains the following excerpts:

Chapter 16A - Interest Maintenance Reserve

All U.S. life insurance companies and fraternal benefit societies are required to establish an Interest Maintenance Reserve (IMR) for realized gains and losses resulting from changes in the overall level of interest rates on fixed income investments. The IMR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the IMR are periodically revised, the current publications should be consulted.

The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized capital gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold. The IMR applies to realized capital gains and losses, net of tax, on short-term and long-term fixed income securities, including bonds, notes, preferred stock and mortgages.

Chapter 16B - Asset Valuation Reserve

All U.S. life insurance companies and fraternal benefit societies must include as a liability in their statutory financial statement an Asset Valuation Reserve (AVR) on fixed income and equity investments. The AVR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life, Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the AVR are periodically revised, the current publications should be consulted.

The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.

The AVR contains two components, default and equity, each designed to address specific asset risk areas. The default component is further divided into the bond and preferred stock subcomponent and the mortgage subcomponent; the equity component is comprised of the common stock subcomponent and the real estate and other invested asset subcomponent. Increases or decreases to the reserve are charged or credited directly to surplus. The AVR is limited to maximums by subcomponent, and no subcomponent of the AVR may be less than zero. Transfers between subcomponents or between components may be required or may be allowed without commissioner approval when negative or certain maximum subcomponent balances occur.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 10, 16 and 25
- NAIC Annual Statement Instructions
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies
- Minutes to the Separate Accounts Working Group Meeting of June 5, 1995
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 5—Life Contracts*
- *Issue Paper No. 52—Deposit-Type Contracts*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*

- *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*
- *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises*

State Regulations

- Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*

Other Sources of Information

- Draft discussion material from previous Life Codification projects, Chapter 16A, *Interest Maintenance Reserve*, and Chapter 16B, *Asset Valuation Reserve*