



### 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.





**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 Tc 0.0871 onee b-6(aenefit a-6(finds way be upu in o maseparate ac

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

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.



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.

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## Separate Accounts

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





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

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

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



## 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*