



# POLYSYSTEMS, INC. HORIZONS

March 2009

Issue #48  
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For info on how PolySystems can ease your transition, visit our website or call Bob Keating at 312.332.5670 to learn more.

## Enhanced Processing for DAC Ceilings: One Solution for Negative Amortization

—Robert J. Lemke, FSA, MAAA, Vice President

Market conditions in 2008 were less than good. Actually, that might be a little generous. Market conditions in 2008 were the worst the world has seen in decades.

Over the past several months, companies have experienced significant realized and unrealized losses. As current market conditions persist, this will continue to be an issue.

Significant realized and unrealized losses lead to negative Estimated Gross Profits (EGPs) in FAS 97 blocks of business and negative amortization. Negative amortization increases both DAC and Shadow DAC amounts. When negative amortization occurs, a DAC ceiling may need to be applied.

There are currently a few techniques for handling negative EGPs and negative amortization in PolySystems software. Although we have always calculated a DAC ceiling, the need to apply the ceiling has never existed like it does today. Consequently, we have enhanced our FAS 97 process to allow the optional application of the DAC ceiling.

### Negative EGPs

Paragraph 22 of SFAS 97 states, "If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as the base for computing amortization." In practice, this change in amortization basis is rarely implemented because of potential distortions and inconsistencies in GAAP results.

In situations where negative EGPs are the result of isolated events (such as a large drop in the stock market), companies have typically taken one of the following approaches:

- Set negative EGPs to zero to prevent negative amortization.

- Allow negative EGPs and the resulting negative amortization, but cap the DAC at the sum of deferrable expenses (i.e., apply a DAC ceiling without interest).
- Allow negative EGPs and the resulting negative amortization, but cap the DAC at the sum of deferrable expenses accumulated at the GAAP discount rate (i.e., apply a DAC ceiling with interest).

### Current Options in PolySystems Software

Each approach can be taken using PolySystems software.

#### 1. Set negative EGPs to zero.

Our FAS 97 software currently allows negative EGPs to be set to zero. This floor is set at the cohort level using the *Amortization and Accrual Rules* screen.

The following options are available:

Monthly	If the EGP for the month is negative, it is set to zero.
Quarterly	If the total EGP for a calendar quarter is negative, then the EGPs for all three months of that quarter are set to zero.
Annually	If the total EGP for a calendar year is negative, then the EGPs for all twelve months of that year are set to zero.

The *Amortization and Accrual Rules* screen also allows you to place additional constraints as to what portion of the PCF or HCF to check for negatives (e.g., only check before or after the valuation date or before or after a specified date).

## 2. *Capping the DAC at the sum of the deferrable expenses with or without interest.*

Projection Report 102 shows DAC ceilings with and without interest. These are informational vectors only. Using our vector utility programs, you can compare the calculated DAC to the ceiling amounts at the cohort, partition or total line-of-business level. If your DAC balance exceeds the ceiling, you may wish to reduce the reported DAC. This is currently a manual process, but our new enhancements will automate this process.

## 3. *Alternate basis*

If you determine that using an alternate amortization basis is the appropriate approach, you can choose among the following options in the *Amortization and Accrual Rules* screen:

Revenue	Uses vector 4006, GAAP Revenues, as the amortization basis.
Inforce	Uses vector 3004, Death Ben Inforce, as the amortization basis.
Cost	Uses vector 5006, GAAP Expenses, as the amortization basis.

## New Features in PolySystems' FAS 97 Reporting Software

We added a new option in the *Amortization and Accrual Rules* screen titled *Treatment of DAC/FEL/SIA Ceilings* with the following system options:

- IGNORE CEILINGS (this is the default and matches current processing)
- USE CEILINGS WITH INTEREST
- USE CEILINGS WITHOUT INTEREST

The new processing creates a new set of *reported* Deferred Acquisition Cost (DAC), Front End Load (FEL) and Sales Inducement Asset (SIA) vectors. The *calculated* DAC, FEL and SIA vectors are not changed by this enhancement; thus, two sets of vectors are now created: a reported series and a calculated series.

If either USE CEILINGS WITH INTEREST or USE CEILINGS WITHOUT INTEREST is selected, the *reported* DAC, FEL and SIA amounts are the lesser of the *calculated* amounts and the selected ceiling amounts. If the IGNORE CEILINGS option is selected, the *reported* amounts are set equal to the *calculated* amounts.

The *reported* amounts are not written back to the HCFs when the amounts are locked in for the reporting period, as this enhancement is not intended to be a

permanent write-down of the DAC, FEL or SIA. Instead, the ceiling is a constraint placed upon the DAC, FEL and SIA amounts, and it will be re-evaluated at each reporting period. The *calculated* amounts will continue to be recorded in the HCFs as before.

The *reported* amounts are calculated at the cohort level, and the new vectors are written to the RCFs. Six new reports are created which will also include ceiling amounts calculated at the partition level and in total.

The new *reported* vectors are used instead of the *calculated* vectors in *Report 180: FAS97 Balance Sheet Amounts* and throughout the 2000-series GAAP income statement and balance sheet reports. In addition, six new projection reports have been added:

- Report 190: DAC Ceilings
- Report 191: FEL Ceilings
- Report 192: SIA Ceilings
- Report 290: DAC Ceilings - Shadow DAC
- Report 291: FEL Ceilings - Shadow DAC
- Report 292: SIA Ceilings - Shadow DAC

The above reports show totals for the following items, as applicable, at the cohort level, partition level and in total:

- Policies Inforce
- Face Amount / 1000
- Fund Value
- Calculated DAC, FEL or SIA
- DAC, FEL or SIA Ceiling with Interest
- DAC, FEL or SIA Ceiling without Interest
- Chosen DAC, FEL or SIA Ceiling
- Reported DAC, FEL or SIA

Significant unrealized losses will not be a permanent issue, but they are an issue now. We designed this new processing thinking about the current market volatility. A process that used to be manual is now automated. As market conditions change, the *reported* sets of vectors will automatically be re-evaluated at every reporting period.

These great enhancements are available in time for first quarter financial reporting. The changes have been incorporated into UL and Annuity versions 9.6 and higher and into Life (for plans with a FAS 97 component) versions 4.4 and higher.

If you wish to incorporate this enhancement into your financial reporting process, please contact Bob Keating at [BKeating@polysystems.com](mailto:BKeating@polysystems.com) or via telephone at 312-332-5670. Feel free to contact me with any questions regarding the issues of negative FAS 97 EGPs and negative amortization at [BLemke@polysystems.com](mailto:BLemke@polysystems.com). 