

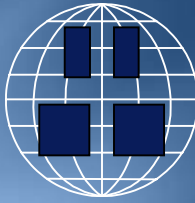
ACTUARIES CLUB OF THE SOUTHWEST

SOP 03-1: Nontraditional Long-Duration
Contracts and Separate Accounts

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PolySystems Inc.

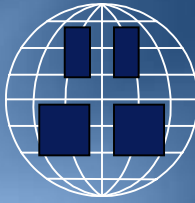
June 17, 2004

Agenda



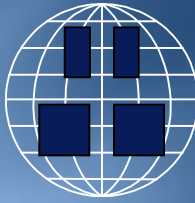
- Focus of SOP 03-1
- Issues and Implications
- Areas of Interpretation

Overview



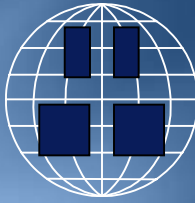
- SOP 03-1 is the most significant GAAP pronouncement in years
- Adopting SOP 03-1 should be reported as a cumulative effect of a change in accounting principle with no restatement of prior financial statements

Background



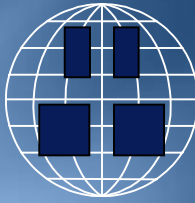
- Innovative Policy Design
- Inconsistent Accounting Treatment
- AcSEC Charge was to Give Guidance on Existing FASB Statements
- SOP was Not to Change or Correct Anything in Original FASB Statements
- Approved and Released on July 7, 2003

Focus of SOP 03-1



- Separate Account
 - Presentation
 - Insurance Enterprise's Interest
 - Transfers
- Valuation of Liabilities
 - Accrued Account Balance
 - Mortality and Morbidity Risks
 - Annuitization Benefits
- Sales Inducements
- Disclosures
- Effective Date and Transition

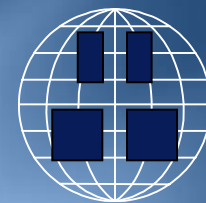
Separate Accounts



Separate Account Criteria

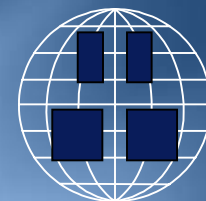
- “The portion of separate account assets representing contract holder funds should be measured at fair value and reported in the insurance enterprise’s financial statements as a summary total, with an equivalent summary total reported for related liabilities” (Paragraph 11)
- Must meet following conditions
 - a. SA legally recognized
 - b. SA assets legally insulated from GA liabilities
 - c. Contract holder directs investment in SA funds
 - d. Investment performance (net of fees and assessments) passed through to contract holder

Separate Accounts



- Some products do not meet these criteria
 - Examples are fixed account options of variable contracts, MVAs, GICs, and indexed contracts because investment performance is not passed through to the contract holder
 - Assets and liabilities held in SA should be accounted the same as other GA assets and liabilities
- Liabilities for minimum guarantees held in GA

Separate Accounts

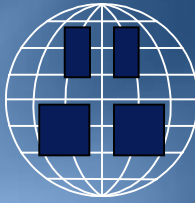


- Insurance Enterprise's Interest
- Transfers

Implications

- Need to determine each SA individually
- Could result in greater volatility in the Income Statement

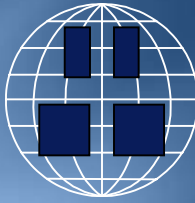
Valuation of Liabilities



Accrued Account Balance

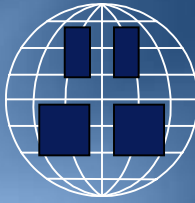
- Accrued account balance equals
 - a. Deposits net of withdrawals
 - b. Plus credited amounts (guaranteed and excess)
 - c. Less fees and charges
 - d. Plus additional interest (persistence bonus)
 - e. Plus other adjustments (return on reference pool of assets)

Valuation of Liabilities



- Accrued account balance based on highest contractually determinable balance that will be available in cash or its equivalent (2-Tier Annuities)
- Accrued account balance should not reflect surrender adjustments (Market Value Adjustment Annuities)

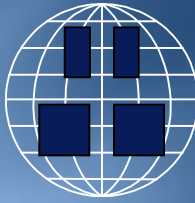
Mortality / Morbidity Liabilities



Mortality and Morbidity Risks

- Examples: GMDB & GMIB
- First determine whether the contract is an investment or insurance contract
 - Existing Contract Classified at inception of SOP
 - New Contract Classified at Issue
 - Not reassessed during the accumulation phase
- Investment contract if mortality / morbidity risk is nominal, insignificant, or remote probability; otherwise insurance contract

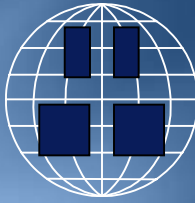
Mortality / Morbidity Liabilities



Paragraph 24

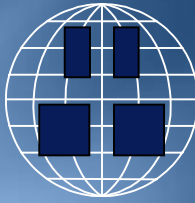
“There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility.”

Mortality / Morbidity Liabilities



- FASB 97 universal life-type contract if
 - Mortality / morbidity risk is other than nominal,
 - Fees assessed or insurance benefits are not fixed and guaranteed, and
 - Long duration
- FASB 60 type contract if
 - Mortality / morbidity risk is other than nominal, and fees assessed or insurance benefits are fixed and guaranteed, or
 - Short duration

Mortality / Morbidity Liabilities



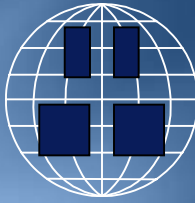
Determination of significance of mortality / morbidity risk based on the ratio of

PV(expected excess payments) and

PV(expected total assessments)

- Total assessments includes investment margin on GA liabilities
- Consider frequency / severity under full range of scenarios (Interest & Equity)

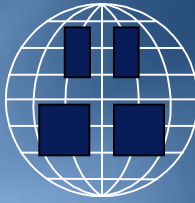
Mortality / Morbidity Liabilities



Paragraph 26

“If the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function, a liability should be established in addition to the account balance to recognize the portion of such assessments that compensates the insurance enterprise for benefits to be provided in future periods.”

Mortality / Morbidity Liabilities



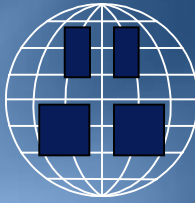
- Amount of additional liability is based on the benefit ratio, where

Benefit ratio =

$$\frac{\text{PV}(\text{total expected excess payments})}{\text{PV}(\text{total expected assessments})}$$

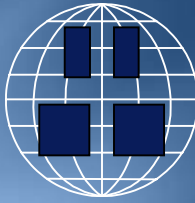
- May exceed 100%
- Expected assessments include all charges – administration, mortality, expense and surrender
- Investment margin should be included for GA

Mortality / Morbidity Liabilities



- “Expected experience should be based on a range of scenarios rather than a single set of best estimate assumptions” (Paragraph 26)
- Assumptions used (interest rates, discount rate, lapse rate, mortality rate) should be consistent with assumptions used in EGP used in amortizing DAC
- Insurance enterprise should regularly evaluate estimates

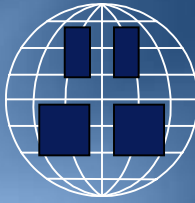
Mortality / Morbidity Liabilities



Additional mortality / morbidity liability =
Current benefit ratio × cumulative assessments

- cumulative excess payments
 - + accreted interest
-
- Not less than zero
 - Change recognized as benefit expense
 - Change recognized in EGPs used to amortize DAC

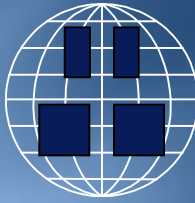
Annuitization Liabilities



Annuitization Benefits

- Payable only upon annuitization
- Examples: purchase guarantees, GMIB, and two-tier annuities
- Additional liability only needed if the contract feature does not fall under FASB 133
- Additional liability established if at annuitization the $PV(\text{annuitization benefits}) > PV(\text{expected account value})$
- Applicable to both insurance and investment contracts

Annuitization Liabilities



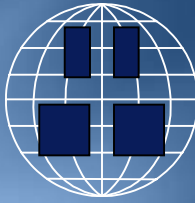
- Amount of additional annuitization liability is based on the benefit ratio, where

Benefit ratio =

$$\frac{[\text{PV}(\text{expected annuitization payments} + \text{incremental claim adjustment expenses}) - \text{expected accrued account balance}]}{\text{PV}(\text{expected assessments})}$$

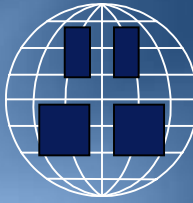
- Discount rate for annuity payments is the estimated investment yields expected during the annuitization phase

Annuitization Liabilities



- Expected experience should be based on a range of scenarios that considers volatility rather than a single set of best estimate assumptions
- Assumptions used (interest rates, discount rate, lapse rate, mortality rate) should be consistent with assumptions used in estimating EGPs used in amortizing DAC
- Insurance enterprise should regularly evaluate estimates

Annuitization Liabilities



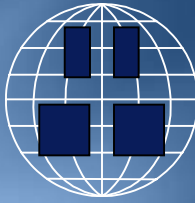
Additional Annuitization liability =

Current benefit ratio × cumulative assessments

- cumulative excess payments determined at annuitization
- + accreted interest

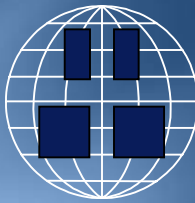
- Not less than zero
- Change recognized as benefit expense
- Change recognized in EGPs used to amortize DAC

Sales Inducements



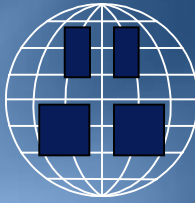
- Examples: Day-one bonus, persistency bonus, enhanced credited rate
- SI liability should be recognized over the period in which the contract must remain in force to qualified for the inducement or at the crediting date, if earlier
- No adjustment to SI liability for surrender charges, persistency, or early withdrawal features

Sales Inducements



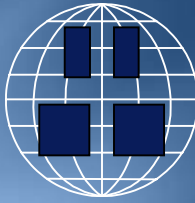
- To deferred and amortize SI, the insurer must demonstrate that
 - SI are recognized as part of the liability
 - Explicitly identified in the contract at inception
 - Meet the following criteria
 - Incremental to amounts credited on similar contracts without sales inducements, and
 - Higher than the contract's expected ongoing crediting rates

Sales Inducements



- Deferred SI – DAC-type asset
- SI deferred and amortized using same methodology and assumptions used to amortized DAC
- Deferred amount recognized as an asset and amortized amount recognized as a benefit expense
- SI deferred amount amortized over accumulation phase

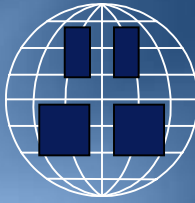
Disclosures



The following information should be disclosed

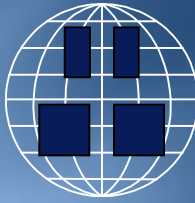
- General nature of contracts in SA
- Basis of presentation for SA
- Disclosures for minimum guarantees should include
 - SA liability balances
 - Liability by type of benefit
 - NAR and average weighted attained age
- The aggregate fair value of assets supporting SA with additional insurance benefits and minimum investment returns
- Amount of gains and losses of assets transferred

Areas of Interpretation



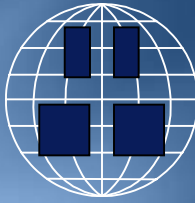
- UL contracts: “Gains followed by losses”
- UL contracts: Liability for policy with reverse select/ultimate COI vs. URR
 - Additional FASB guidance
- Stochastic modeling
- Levels of aggregations
- Reinsurance credits
 - SOP reserve determined gross of reinsurance
 - Need to comply with FAS 113 in treatment of YRT reinsurance

Areas of Interpretation (Cont)

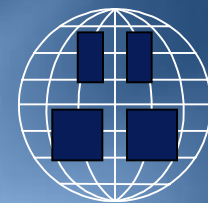


- Iterative approach for contracts with SI and GMDB
- Amortization period
- Accounting for SI at inception

Additional Information



- American Academy of Actuaries Practice Note
- FASB Staff Position – FAS 97a
Require Accrual of an Unearned Revenue Liability



Questions?