



SOCIETY OF ACTUARIES

**US GAAP for International Life Insurers – Hong Kong
June 2008**

Session 13: Internal Replacements – SOP 05-1

Charles Carroll

DAC on Replacements – SOP 05-1

US GAAP for International Life Insurers
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Agenda

- Statement of Position (SOP) 05-1
 - Basics of SOP 05-1
 - Illustrative examples
 - Implementation issues
 - Recent developments



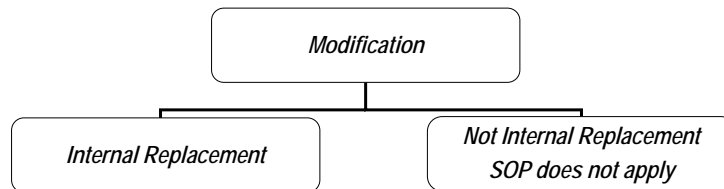
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Basics of SOP 05-1

“Internal Replacement” – modification in product benefits, features, rights or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract, or by amendment, endorsement, or rider to a contract, or by the election of a benefit feature, right or coverage within a contract.



Internal Replacement versus Not Internal Replacement



Modifications that are not internal replacements

Modifications that result from the election of a benefit within the original contract are not internal replacements as long as all of the following conditions are met:

- Terms are fixed or specified within narrow range
- Election of the benefit is not subject to underwriting
- Insurance enterprise cannot decline to provide the coverage or adjust the pricing of the benefit
- Feature has been accounted for since the inception of the contract or the existence of the benefit was contemplated in original contract classification



Integrated Features

- If the contract modification was not contemplated within the original contract, determine whether the modified contract features are integrated or not integrated with the base contract
 - For long duration contracts the feature is integrated if the benefit provided can only be determined in conjunction with the base contract.
 - Examples of integrated contract features: GMDBs, GMABs, GMIBs, premium waiver

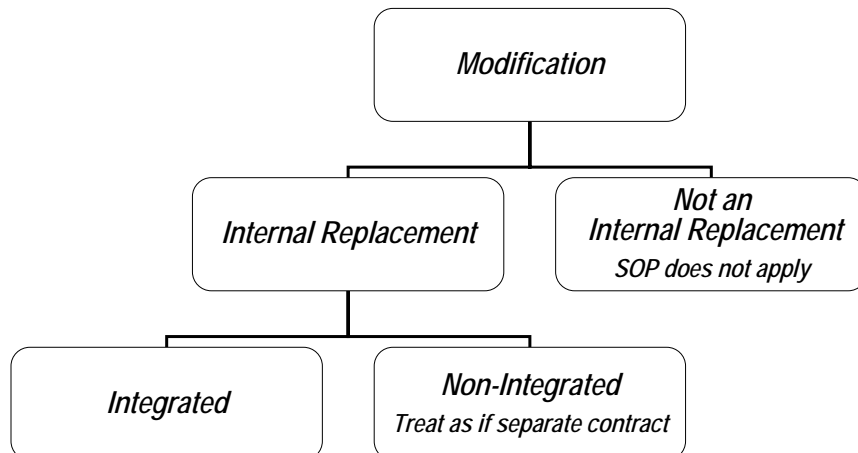


Non-Integrated Features

- If not integrated, the contract feature does not impact the base contract, and is accounted for as if it were a separate contract
 - Long-duration: LTC rider to annuity contract, term life rider to annuity contract, spousal term rider
 - Short-duration: New driver on an existing automobile contract, personal articles floater to a homeowners contract
- If the modification is integrated with the base contract, or considered an exchange of one contract for another, has the modification resulted in a “substantially unchanged” contract?



Decision Tree

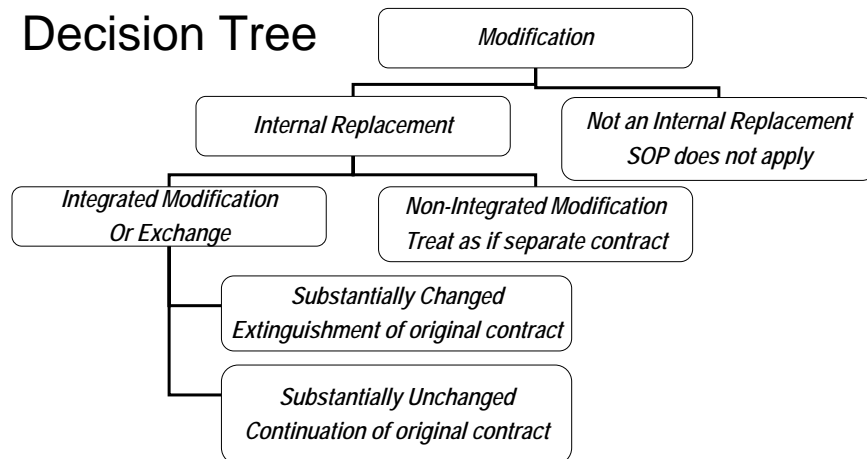


Meaning of “Substantially Unchanged”

- Insured event of the contract has not changed
- Nature of investment return rights (e.g., formulaic, pass-through, discretionary) has not changed
- No additional deposit, premium, or charge is required to effect the transaction
- No net reduction in the contract holder’s account value or cash surrender value
- No change in the participation or dividend features of the contract
- No change to the amortization method or revenue classification of the contract



Decision Tree



Substantially Unchanged Contracts

If substantially unchanged, then:

- Replacement contract is considered a continuation of the original contract
- Unamortized DAC, deferred revenue liability, deferred sales inducement asset, and other balances associated with the original contract continue to be deferred in connection with the replacement contract
 - FAS 60 contracts: “prospective revision” – preserves lock-in
 - FAS 97 contracts: revision of future EGPs/EGMs of the original contract
- Costs incurred in connection with the internal replacement are maintenance-type costs – expense when incurred



Substantially Changed Contracts

If substantially changed:

- Accounted for as an extinguishment of the initial contract
- Unamortized DAC, deferred revenue, and deferred sales inducement asset from the original contract are written off
- Acquisition costs incurred in connection with the internal replacement are evaluated for deferral in accordance with the provisions of FAS 60 and 97



DAC on Internal Replacements

- Disclosure
 - Describe accounting policy for internal replacements
 - Whether company availed itself of practicability exception
- Effective for years beginning after December 15, 2006
 - Retrospective application not permitted
 - Disclose effect on adoption of changes in estimated gross profits
- SAB 74 disclosures applicable for 2006 reporting



Illustrative SOP 05-1 Examples



Reinstatements

- Under SOP 05-1, reinstatements, if outside the “grace period” for late premium payment, are considered to be new contracts
- In US, reinstatements are relatively rare, and most companies do not have administrative capability to treat them as new contracts
- For this reason, most companies ignore on the basis of materiality
- In Asia, the volume of reinstatements can be significant



Traditional Life Insurance

- Scenario
 - Policy owner exercises contractual right to purchase additional life insurance coverage without underwriting on Traditional Life policy
 - Additional premium is not excessive
- Analysis
 - Nonintegrated

Conclusion: Treated as a separate contract



Universal Life – Case 1

- Scenario
 - UL face amount is increased through contract amendment
 - Only additional face amount is underwritten
- Analysis
 - Substantially unchanged since it meets the “six conditions”
 - No change in insured event
 - No change in charges related to original benefits
 - No change in investment return rights
 - No change in participation or dividend feature
 - No net decrease in account balance
 - No change to amortization method or revenue classification

Conclusion: Treated as continuation of original contract



Universal Life – Case 2

- Scenario
 - UL exchanged for UL with no-lapse guarantee
- Analysis
 - Substantially changed since the no-lapse guarantee:
 - Changes period of coverage
 - Changes mortality and investment risk

Conclusion: Original contract considered extinguished



Variable Annuity – Case 1

- Scenario
 - VA with return of premium DB to VA with ratchet DB
- Analysis
 - Substantially changed since mortality risk changed

Conclusion: Original contract considered extinguished



Variable Annuity – Case 2

- Scenario
 - New investment alternatives added to VA
- Analysis
 - Usually, substantially unchanged
 - However, it might be substantially changed in certain circumstances with a fixed return option

Conclusion: Treated as continuation of original contract



Variable Annuity – Case 3

- Scenario
 - Policyholder election of base for GMWB benefit
- Analysis
 - Election of an option in the contract where terms are not specified within a narrow range
 - Integrated
 - Substantially changed?

Conclusion: Could be an extinguished contract and new issue depending on significance of change



Impact on GAAP Assumptions

- The transfer of DAC from the replaced policies to the new policies may force companies to move towards a more granular level for DAC amortization
- Lapse assumption could be updated to allow for future substantially changed or substantially unchanged modifications
- The internal replacement activities may lead to
 - Lower future lapse rates for the original cohort
 - Higher mortality due to anti-selection
 - Changes in other assumptions such as interest rate spread of the original cohort of policies



Recent Developments

- Much confusion and frustration in applying the guidance
- Technical practice aids (TPA 6300) issued by AICPA
- Examples of TPA guidance
 - Replacements
 - Changes in investment management fees
- “It depends”



Recent Developments

- Companies disclosures indicate limited impact on financial statements
- Most significant impacts were related to group insurance contracts that are renegotiated regularly

