



SOCIETY OF ACTUARIES

**International Financial Reporting for Insurers: IFRS
and U.S. GAAP
September 2009**

**Session 9: Investment Accounting and Shadow
Adjustments – SFAS 115**

Peter Duran

SFAS 115 – Investment Accounting and Shadow Adjustments

Hong Kong – September 2009
Peter Duran, Deloitte



Agenda

- Basic SFAS 115
- Asset Classifications
- Shadow Adjustments
- Other Considerations



SFAS 115 – Accounting for Certain Investments in Debt and Equity Securities

- Effective beginning in 1994
- Applies to debt securities and to equities that have readily-determined fair values

2



EITF D-41

- Emerging Issue Task Force No. 41
- Published by the SEC January 20, 1994
- SEC staff's position on FAS 115 on certain assets and liabilities, e.g. life insurance policyholder liabilities, DAC, and VOBA
- Shadow Adjustment

3



Classification of Securities

Classify at outset and change only in
extraordinary circumstances

Debt securities

1. Held-to-maturity
2. Trading
3. Available for sale

Equity securities

1. Trading
2. Available for sale

4



Held-to-Maturity (HTM)

- Only available for debt securities
- Use only if there is the positive intent and ability to hold the security to maturity
- Carry at amortized cost on the balance sheet
- Reclassification risks “tainting” the entire HTM portfolio
- Seldom used due to the restrictions

5



Trading

- Available for debt and equity securities
- Intended for securities bought for the purpose of selling in the near term
- Carry at fair value on the balance sheet
- Unrealized gains and losses are included in earnings

6



Available-for-Sale (AFS)

- Available for debt and equity securities
- Defined as anything that isn't classified as HTM or Trading
- Carry at fair value on the balance sheet
- Unrealized gains and losses are reflected in equity (other comprehensive income, aka OCI)
- Realized gains and losses are reflected in earnings

7



What is Other Comprehensive Income (OCI)?

- Comprehensive Income = Change in Equity for the period (excluding ownership type equity such as stocks)
- Comprehensive Income =
Net Income + Other Comprehensive Income
- OCI:
 - Unrealized Gains and Losses from AFS
 - Unrealized pension cost from minimum pension liability adjustment
 - Translation gains and losses
 - UR G/L from cash flow hedges (FAS 133)
 - UR G/L from foreign currency hedges (FAS 133)
- Per SFAS 130

8



Summary of Classifications

<u>Classification</u>	<u>Balance Sheet Carrying Value</u>	<u>Treatment of Change in Fair Value</u>
Held-to-Maturity	Amortized Cost	N/A
Trading	Fair value	Net Income
Available-for-Sale	Fair value	Unrealized: OCI Realized: Net Income

9



Other Considerations

- Other-than-temporary impairments
 - Credit deterioration
 - FSP 115 - 2
- Treatment of other assets
- Treatment of the liabilities backed by the assets

10



Shadow Adjustments

- EITF D-41
- Adjust certain balance sheet items assuming that unrealized gains and losses on AFS securities are realized
- Generates consistency in the balance sheet
- Cushions the impact of movements in valuations caused by e.g. interest rate movements

11



Types of Shadow Adjustments

- Shadow DAC
- Shadow VOBA
- Shadow Unearned Revenue Liability
- Shadow Loss Recognition

12



Amortization Example - Universal Life

Back to the original example
In year 3, there is an **unrealized** capital gain of 200
DAC for the **income statement** is as before

<u>Year</u>	<u>Projected EGP</u>	<u>EOY DAC</u>
1	100	160
2	100	120
3	100	80
4	100	40
5	100	0
PV @ 0 %	<u>500</u>	

Amortization Ratio = 200 divided by 500 = 40 %

13



Amortization Example - Universal Life

However, the **balance sheet** is presented as if the gain had been realized

<u>Year</u>	<u>Projected EGP</u>	Recalculated <u>DAC</u>
1	100	160
2	100	120
3	300	0
4	0	0
5	0	0
PV @ 0 %	<u>500</u>	

Amortization Ratio = 200 divided by 500 = 40 %

14



SFAS 115 Adjustment to Other Comprehensive Income for AFS Security

Unrealized Gain	200
Less:	
Adjustment to DAC	80
Adjustment to Equity Capital before Tax	120
Deferred Federal Income Tax	42
Net Adjustment to Equity Capital	78

15



Estimating the Shadow DAC Adjustment

- An exact calculation of shadow DAC will normally result in a revised k factor
- However, the change in k -factor will normally be small because timing gains/losses are economically neutral events
- Estimated shadow DAC adjustment =
 $\text{DAC } k\text{-factor} \times \text{AFS unrealized capital gains or losses}$

16



Shadow Loss Recognition Reserve

- Typically an issue on FAS 60 products because of locked-in assumptions
- Recently observed on single premium group annuities
- Typically occurs in declining interest rate environments

17



Shadow Loss Recognition

- Asset = 15 year bond
- Unrealized Gain = 250
- Liability = 10 Year Annuity 1,000 annually
- Current Portfolio Yield = 8%
- Reserve = 6,710 (at 8%)

18



Shadow Loss Recognition

- Current Interest Rates = 7.5 %
- Reserve @ 7.5 % = 6,864
- Unrealized Gain = 250
- Shadow Loss Recognition Adjustment = 154

19



SFAS 115 Adjustment to Other Comprehensive Income for AFS Security (2)

Unrealized gain	250
Less:	
Loss recognition adjustment	<u>154</u>
Adjustment to Equity capital before tax	96
- Deferred federal income tax	34
Net adjustment to OCI	62

20



Other Shadow Adjustments

- Unearned revenue liabilities
- Policyholder dividend obligations
- VOBA
- Sales inducement assets
- Claim reserves

21



Other FAS Impact

- FAS 133 impacts the application of FAS 115 in some instances.
- FAS 157 amends part of FAS 115 for measuring fair value for certain securities.

22



Any Questions?



23

