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Asset Implications for DAC

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Asset Implications on DAC

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Agenda

- Treatment of asset movements in DAC
- Implications on DAC movement
- Recent Guidance
- Examples

Treatment of Asset Movements in DAC

- Realized capital gains and losses included in FAS 97 DAC
- AICPA Practice Bulletin 8 states “*Expected gains and losses from sales of investments related to universal life contracts should be included in the determination of EGP, because earned investment income should be based on the expected total yield of the investments*”
- This would typically include realized gains and losses driven by Other Than Temporary Impairments (OTTI)
 - As defined by FAS 115 and subsequent FSPs
 - Probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition
- Includes gains and losses from hedging activities
- Unrealized gains (for assets not designated as trading) not captured in DAC from a net income perspective, but reflected on the balance sheet via shadow DAC
 - Shadow DAC basically calculated like base DAC, but assume unrealized gains and losses are realized
 - Some use a shortcut approach – adjustment equals k-factor x unrealized amount

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Implications on DAC Movements

- Inclusion of realized gains and losses
 - Significant realized gains may imply loss recognition (as those gains result in future investment income reductions)
 - Significant realized losses may result in capping of DAC at original deferrals (with or without interest), especially if negative EGPs are not floored at zero
- Hedging gains and losses
 - Tend to be significant and volatile, resulting in large DAC impacts, but offset by liability movements (if hedging GAAP earnings)
 - DAC impact tends to act as a volatility buffer
- Shadow DAC mechanics
 - Separate DAC cap test required
 - Significant unrealized gains may imply loss recognition on a shadow basis (as those gains result in future investment income reductions)

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Recent Guidance

- Additional complexity introduced with issuance of FASB Staff Position 115-2 in April 2009
- Overview of Guidance:
 - For debt securities, requires bifurcation of credit-related and other market driven losses for securities to be held to disposition
 - Credit impairments flow through net income
 - Other loss components flow through OCI
- Implications on DAC
 - Credit impairment related losses impact base DAC, comparable to realized gains and losses
 - Other loss components impact shadow DAC, comparable to unrealized gains and losses

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Examples

- Deferred Annuity with the following baseline assumptions:
 - Initial deposit: \$100,000
 - Acquisition expenses: \$5,000
 - Separate account return: 10.0%
 - M&E fees: 2.0%
 - Expense loads: 2.0% of account value
 - Maintenance expenses: 2.0% of account value
 - Lapse rate: 2.0% all years
 - Projection period: 5 years

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Examples

DAC Amortization							
Original Projection							
	PV	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Account Value EOP		100,000	103,680	107,495	111,451	115,553	119,805
EGPs	8,548		2,000	2,074	2,150	2,229	2,311
Amortization Ratio (k)	0.584962						
DAC Balance EOP		5,000	4,230	3,356	2,366	1,252	-
DAC Amortization			1,170	1,213	1,258	1,304	1,352
Change in GAAP Equity			1,230	1,199	1,161	1,114	1,059
Realized Loss in 2009							
	PV	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Account Value EOP		100,000	103,680	107,495	111,451	115,553	119,805
Realized Loss (2009) and Reinvestment Income			(100)	20	20	20	20
EGPs	8,516		1,900	2,094	2,170	2,249	2,331
Amortization Ratio (k)	0.587109						
DAC Balance EOP		5,000	4,284	3,398	2,396	1,267	-
DAC Amortization			1,116	1,229	1,274	1,320	1,369
Change in GAAP Equity			1,184	1,207	1,168	1,120	1,064

Typically, inclusion of interest rate related realized gains and losses have a small impact on the k factor, since current loss (gain) is largely offset by future gain (loss) from higher (lower) investment income

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Examples

Unrealized Loss in 2009							
	PV	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Account Value EOP		100,000	103,680	107,495	111,451	115,553	119,805
Unrealized Loss (2009) and Reinvestment Income			(100)	20	20	20	20
EGPs	8,516		1,900	2,094	2,170	2,249	2,331
Amortization Ratio (k)	0.587109						
Shadow DAC Balance EOP		5,000	4,284	3,398	2,396	1,267	-
DAC Amortization			1,116	1,229	1,274	1,320	1,369
Change in GAAP Equity			1,184	1,207	1,168	1,120	1,064
Shadow DAC using shortcut method			4,289				
OTTI Loss in 2009							
	PV	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Account Value EOP		100,000	103,680	107,495	111,451	115,553	119,805
OTTI (2009)			(100)				
EGPs	8,455		1,900	2,074	2,150	2,229	2,311
Amortization Ratio (k)	0.591368						
DAC Balance EOP		5,000	4,276	3,392	2,392	1,265	-
DAC Amortization			1,124	1,226	1,271	1,318	1,367
Change in GAAP Equity			1,176	1,189	1,150	1,102	1,046

In performing shadow DAC analysis, common shortcut approach uses same k factor times unrealized OTTI typically hits actual profits, but because credit-related typically no impact on future gross profits "Shadow DAC" here means base DAC plus shadow adjustment

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Examples

OTTI Loss in 2009 - Impact of FSP 115-2							
	PV	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Account Value EOP		100,000	103,680	107,495	111,451	115,553	119,805
Credit related loss			(200)	40	40	40	40
Interest related gain			100	(20)	(20)	(20)	(20)
EGPs	8,485		1,800	2,114	2,190	2,269	2,351
"Shadow" EGPs	8,516		1,900	2,094	2,170	2,249	2,331
Amortization Ratio (k)	0.589272						
Shadow k	0.587109						
DAC Balance EOP		5,000	4,339	3,441	2,426	1,283	-
DAC Amortization			1,061	1,245	1,290	1,337	1,385
Shadow DAC Balance EOP		5,000	4,284	3,398	2,396	1,267	-
DAC Amortization			1,116	1,229	1,274	1,320	1,369
Change in GAAP Equity			1,184	1,207	1,168	1,120	1,064

Credit related losses reflected in net income, and therefore "base" EGPs. Although is most typical not to show reversal of credit related losses, reversal is shown here as a possible alternative approach (as compared to slide 7)

Interest related gains impact shadow DAC calculations only

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Examples

Realized Loss in 2009, hit DAC cap							
	PV	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Account Value EOP		100,000	103,680	107,495	111,451	115,553	119,805
Realized loss (2009) and Reinvestment Income			(2,000)	450	450	450	450
EGPs	8,076		-	2,524	2,600	2,679	2,761
Amortization Ratio (k)	0.619137						
DAC Balance EOP		5,000	5,400	4,270	3,001	1,583	(0)
DAC Amortization			-	1,562	1,610	1,659	1,709

For large realized losses, DAC may exceed original deferrals (with or without interest), resulting in a cap on DAC. This is more likely if AGPs are not floored at zero

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FAS 60 Considerations

- No direct impact on DAC since premium used as amortization base
- Considerations for loss recognition
 - Significant realized gains may imply loss recognition (as those gains result in future investment income reductions)
 - Significant unrealized gains may imply shadow loss recognition

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