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New GAAP Guidance Likely to Be Promulgated for Non-Traditional Products and Separate Accounts

by David C. Scheinerman and Mary S. Saslow

Editor's Note: For more discussion of GAAP reserves for GMDBs, see the article in this issue by Karen Sasveld and David Heavilin.

Introduction

- Should "bonuses" granted on annuity and life insurance contracts be deferred or expensed immediately?
- What is the appropriate accounting for contracts that provide multiple account balances?
- Should (and, if so, how should) insurers reserve for minimum death benefit guarantees?
- Should insurers reserve for enhanced annuitization options such as guaranteed minimum income benefits?
- What is the appropriate accounting for separate accounts in which the insurer bears the investment risk?
- How should an insurer account for seed money investments?

These are some important GAAP accounting questions that are being addressed by the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA). This article provides an overview of some of the key issues addressed and accounting guidance being drafted for a proposed "Statement of Position" (SOP), entitled "Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and for Separate Accounts." An exposure draft of the SOP is expected to be presented to AcSEC and the Financial Accounting Standards Board (FASB) in the third or fourth quarter of this year for approval, after which it would be released for public comment.

Sales Inducements

A bonus immediately credited to a contract holder's account balance, a persistency bonus credited after a specified period, and an enhanced interest rate credited during an initial contract period are examples of sales inducements. The draft SOP defines sales inducements as amounts that are explicitly identified in the contract and are (1) incremental to amounts the enterprise credits on similar contracts without enhanced returns; and/or (2) higher than the contract's expected renewal crediting rates.

AcSEC debated whether sales inducements should be (1) expensed as credited to policyholders, or (2) deferred and expensed over the life of a book of contracts. The former treatment is generally consistent with the accounting guidance for obligations that are payable on demand, which requires accretion of any debt discount to the first possible put date. However, the existing accounting model for investment contracts and universal life-type contracts treats such obligations as long-duration contracts, not as obligations that are payable on demand, even though they are immediately surrenderable. This is evidenced by the fact that qualifying acquisition costs are deferred and amortized over the estimated life of a book of contracts. As further support for deferral, proponents note that recognizing a loss upon issuance of a contract would be inconsistent with the economics of the transaction and with the accounting principle of generally having no immediate accounting gain or loss upon entering into a fair exchange (except when accounting for loss recognition).

AcSEC has tentatively concluded that sales inducements meeting specified criteria should be deferred and expensed over the life of the book of contracts, consistent with the existing long-duration contract accounting model. However, AcSEC believes that sales inducements are not "acquisition costs" or "issuance costs" but instead are benefits payable to contract holders and therefore concluded that such costs should be amortized to benefit expense. AcSEC concluded that consistent with the long-duration model, deferred sales inducements should be amortized using methodology and assumptions similar to that used for deferred acquisition costs. In keeping with the FAS 97 model, which is based on account balance and does not anticipate surrenders, sales inducements are credited to the contract holder account balance (and deferrable amount capitalized) without reduction for anticipated surrender charges, persistency, or early withdrawal contract features. Thus, even if the insurer anticipates that a certain percentage of the sales inducement will ultimately not be paid to the contract holders, the full sales inducement should be recorded.

Liability Valuation

Insurers have introduced annuity and life insurance contracts with features not contemplated when FAS 97 was written, such as contracts with multiple account balances and multiple benefit features. As a result, there is diversity in practice with regard to the accounting for contracts with such non-traditional terms. The proposed SOP guidance interprets several aspects of the FAS 97 liability valuation model, including the definition of the "balance that accrues to the benefit of policyholders" (commonly referred to as the account balance) and the accrual of an additional liability for death benefits and other insurance benefit features.

Definition of Account Balance

The draft describes the accreted account balance as equaling:

(a) deposit(s) net of withdrawals;
(b) plus amounts credited;
(c) less fees and charges assessed;
(d) plus additional interest; and
(e) other adjustments (e.g. appreciation, depreciation)

The draft SOP provides that additional interest should be accreted to that balance which is available in cash or its equivalent using the effective yield method through the contractual maturity date (or through the interest reset date if earlier). For example, in the case of a persistency bonus, the additional amount to be credited would be accreted to the liability through the end of the persistency period since at that time it will be credited to the account balance. If there is more than one potential account balance, the accreted account balance is based on the highest contractually determinable balance that will be available in cash or its equivalent at contractual maturity or reset date. Moreover, the accreted balance should not reflect any surrender adjustments such as market value surrender adjustments, surrender charges or credits.

The draft SOP provides guidance for two-tiered annuities for which one account balance is available in cash and another balance is available for annuitization only. Currently, some companies establish a liability for the greater of these two balances. However, assuming the annuitization option is not available in cash or its equivalent, the draft guidance would provide for an account balance liability accreted to the lower-tier amount available in cash at contract maturity.

Another example of a contract impacted by the draft SOP is a modified guaranteed annuity (sometimes referred to as market value adjusted annuity or MVA) that may have one account balance payable at maturity and another payable upon surrender. There is currently diversity in practice as to whether the accreted balance or the market adjusted balance is reported at each balance sheet date. The proposed guidance would require recording of the accreted balance, excluding any positive or negative market adjustment that would result in the event of surrender.

The draft SOP also provides guidance for contracts that provide a return based on the total return of a contractually referenced pool of assets such as variable annuity and variable life contracts offered through separate accounts and experience-rated pension products offered in the general account. The proposed SOP provides that the liability recorded should be based on the fair value of the referenced pool of assets, with any changes in the liability recorded as an expense. Similarly, if the contract provides a return based on an interest rate index, the accreted account balance should be based on the interest rate index value at the balance sheet date.

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An example of a potentially impacted product would be an experience rated (often referred to as "participating") group annuity contract. If the contract references a particular pool of assets of the insurer and the return available at any given withdrawal date is based on that pool, the SOP will require the liability for such contracts to be based on the fair value of the pool of assets (with any changes in the liability recorded as an expense). In contrast, present practice is to record the liability consistent with the accounting for the related assets.

Additional Liability for Death Benefit and Other Insurance Benefit Features

Insurers continue to offer variable annuities with enhanced guaranteed minimum death benefits (GMDB) beyond the traditional return of premium- for example, a death benefit equal to deposits less withdrawals accumulated at a specified interest rate or a ratcheted death benefit based on the highest account balance at any policy anniversary date. There is currently diversity in practice with regard to the accounting for such features: some insurers record an additional liability for such policyholder benefits and others record no additional liability under the theory that the mortality risk is insignificant or perhaps under the theory that the FAS 97 deposit model does not provide for such an additional accrual.

AcSEC has tentatively concluded that annuity contracts with such death benefit or other insurance benefit features should first be analyzed to determine whether such contracts meet the definition of an insurance contract. This analysis requires the insurer to determine if the mortality and morbidity risk is "other than nominal" as that term is defined in FAS 97 and

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if fees assessed or insurance benefits are not fixed or guaranteed. If this is the case, the contract is classified as a FAS 97 universal-life contract. Significance of the mortality and morbidity risk is determined by comparing the present value of expected excess insurance benefit feature payments (insurance benefit amounts in excess of the account balance) to the present value of fees assessed against contract holders, under reasonably possible outcomes (e.g., through stochastic modeling). This analysis may differ from current practice of determining significance of insurance risk based on a single best estimate scenario.

If the contract is a universal-life type contract and if fees for the insurance benefit do not vary in proportion to the insurance coverage provided for each period, the draft SOP requires the insurer to establish a liability (in addition to the account balance) to recognize the portion of such fees that compensate the insurer for excess insurance benefit payments to be provided in future periods. Support for this additional accrual is by analogy to the FAS 97 requirement to record an additional liability for amounts assessed to compensate the insurer for services to be provided over future periods.

Under the draft SOP, the liability for insurance benefits for such universal life type policies is determined as of each valuation date by:

1) Multiplying the cumulative assessments by the current estimated ratio of the present value of total expected excess insurance benefit payments (and settlement costs) to the present value of total expected assessments over the life of the contract (the bene fit ratio)

2) Subtracting cumulative excess insurance benefit payments and settlement costs, and

3) Adding accreted interest

In effect, a retrospective reserve calculation is required for the insurance benefit feature. Note that the benefit ratio should be estimated using revised assumptions if actual experience or other evidence suggests such revisions, resulting in periodic unlocking adjustments to the liability.

AcSEC also considered whether any additional liability should be accrued during the accumulation phase of an annuity contract for enhanced annuitization options such as guaranteed minimum income benefits (GMIBs) and two-tiered annuities. AcSEC recognized that an insurer may implicitly or explicitly charge an additional fee to the contract holder for such benefits, that some view GMIBs as similar in substance to GMDBs, and that there is potential economic benefit to the various annuitization benefits being offered. However, FAS 97, in describing the annuitization phase of a contract, states that "if purchased, the annuity is a new contract to be evaluated on its own terms." AcSEC therefore concluded that because an annuitization option is an elective benefit that is not part of the accumulation phase of an annuity contract from an accounting standpoint, recognition of an additional liability for such potential benefit is prohibited during the accumulation phase of the contract. Thus, in the case of a two-tiered annuity where the second tier interest crediting rate is only available if the contract is annuitized, no liability would be recorded for that excess interest during the accumulation phase of the contract (consistent with the aforementioned requirement that a liability only be accreted to the amount available in cash or its equivalent). The existing liability at the date of annuitization would be treated as a single premium used to purchase a new annuity contract.

Separate Accounts

The proposed SOP concludes that separate account assets and liabilities should be reported as summary totals in the balance sheet at fair value, provided that the separate account meets all of the following criteria:

- The assets reside in a legally recognized separate account,
- The separate account assets supporting the contract liabilities are legally insulated from the general account liabilities of the insurance company,
- The insurer must invest the contract holder's funds within the separate account as directed by the contract holder or in accordance with specific investment objectives or policies, and
- All investment performance, net of fees, is contractually passed through to the contract holder, and the account values are based entirely on the fair value of the directed investments.

Investment performance on separate accounts meeting the above criteria should be accounted for by offsetting amounts earned on separate account assets with amounts credited to the contract holder in the income statement. Liabilities and expenses related to any associated minimum guarantees, though, would be reported as general account liabilities.

Thus, certain products (such as guaranteed investment contracts, equity indexed annuities, market value adjusted fixed annuities, fixed account options of variable annuities), that may be provided through and currently accounted for as separate accounts, will likely need to be accounted for and reported as general account products.

If an insurer invests non-contract-holder-related funds in a separate account, such an investment would also not meet the above criteria. Thus, the separate account assets underlying the insurer's investment would be reclassified and accounted as general account assets. A typical situation would be seed money investments. If such a separate account is one in which contract holders may purchase additional units, then the assets underlying the insurer's interest in the separate account should be classified and accounted for in a manner consistent with similar assets held by the general account.

In addition, the SOP outlines that if the separate account meets the above criteria, any assets transferred from the general account to the separate account should be recorded at fair value. Losses on such transfers should be recognized immediately in earnings. Gains should be recognized to the extent of the contract holder's proportionate interest in the separate account, provided the transfer otherwise meets the criteria for gain recognition.

Conclusion

Recent annuity and life product innovations have led to product designs not contemplated at the time FAS 60 and FAS 97 were written, and, as a result, a diversity of practice on the accounting treatment for such products has developed. The AICPA, through its Accounting Standards Executive Committee, has developed draft accounting guidance which is anticipated to be exposed for comment later this year. The implications of the guidance are significant, and we recommend that financial reporting and product development actuaries assess and consider these draft recommendations in their financial and product management plans as well as provide input when the draft SOP is exposed for public comment.

Mary S. Saslow, CPA, is a director in the National Office of Pricewaterhouse-Coopers where she specializes in complex and emerging accounting issues impacting the insurance industry. She is a participant in the AICPA's task force on non-traditional long-duration contracts. She can be reached at **mary.saslow@us.pwcglobal.com.**

David C. Scheinerman, FSA, MAAA, IAA, is a principal consultant at Price-waterhouseCoopers LLP in Hartford, CT. He can be reached at **david.c.scheinerman@us.pwcglobal.com.**

Attending the Annual Meeting in New Orleans?

Check Out the Financial Reporting Section Events Scheduled

If you are planning on attending the Annual Meeting this year, be sure to note two events sponsored by the Financial Reporting Section. The first is the Financial Reporting Hot Breakfast, scheduled for Tuesday, October 23 at 7:30 a.m. In addition to a good meal to start off the day, you will be able to attend an open meeting of the Financial Reporting Section Council. Last year the breakfast was very well attended. If you remember, the Section Council received a lot of valuable input from the members on topics like the newsletter, the Section Web Page and meeting sessions and seminars. The meeting promises to be very informative once again, and we look forward to your participation in what has turned out to be an annual success.

The second event is planned for later that same day, Tuesday October 23. A reception will be held at the meeting hotel from 5:30 to 7:00 p.m. for all Section members. This event will give members a chance to socialize on an informal basis as well to hone their networking skills. Whichever is your preference, we hope you will make a point to attend the reception. Tickets will be collected at the door.

The reception is open to Section members and their registered guests only. Please indicate guest attendance on the registration card for the meeting.

So mark your calendars — Tuesday, October 23. Start off the day with the Section Hot Breakfast and end the day with the Section Reception. Sandwiched in between will be a very meaty agenda, for sure!