SOCIETY OF ACTUARIES

Article from:

The Financial Reporter

March 2015 – Issue 100

SOCIETY OF ACTUARIES Financial Reporting Section

The Financial Reporter

ISSUE 100 MARCH 2015

Indexed Universal Life: US GAAP Financial Reporting Practices

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The views expressed are the authors' own and may not represent the views of Oliver Wyman.

Although indexed universal life (IUL) products have existed for more than 15 years, there continues to be a wide range of IUL US GAAP[1] financial reporting practices. This observation prompted Oliver Wyman to perform an industry survey of IUL financial reporting and risk management practices, which was completed in 2014.

This article provides a brief overview of IUL US GAAP financial reporting and expands on the following three survey findings:

1. More than 70 percent of participants use simplified FAS 133 approaches for IUL GAAP liabilities,
2. Full-blown FAS 133 approaches[2] have not converged, and
3. US GAAP creates the most significant financial reporting challenge for IUL.

Background on IUL financial reporting and risk management survey

- 21 participants
- Accounted for 76% of 2013 sales
- Have written IUL for 6 years, on average
- Total face amount of nearly $200B

IUL US GAAP OVERVIEW

Under FAS 133, the liability is bifurcated between an embedded derivative (ED) and a host contract liability (host). The ED measures the value of the derivative features embedded in the contract, such as index-linked

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liabilities. Generally, the ED is sensitive to capital market movements (e.g., index performance and interest rates), whereas the host is more stable and accrued using a fixed interest rate locked-in at issue.

MORE THAN 70 PERCENT OF PARTICIPANTS USE SIMPLIFIED FAS 133 APPROACHES FOR IUL LIABILITIES

Participants were asked to categorize their IUL US GAAP liability approach, ranking from simplified approaches (e.g., using FAS 97 or a simplified FAS 133) to using full-blown FAS 133 approaches (i.e., bifurcation and discounted cash flow method for the ED). The range of approaches used by the 21 participants is described in the exhibit below:

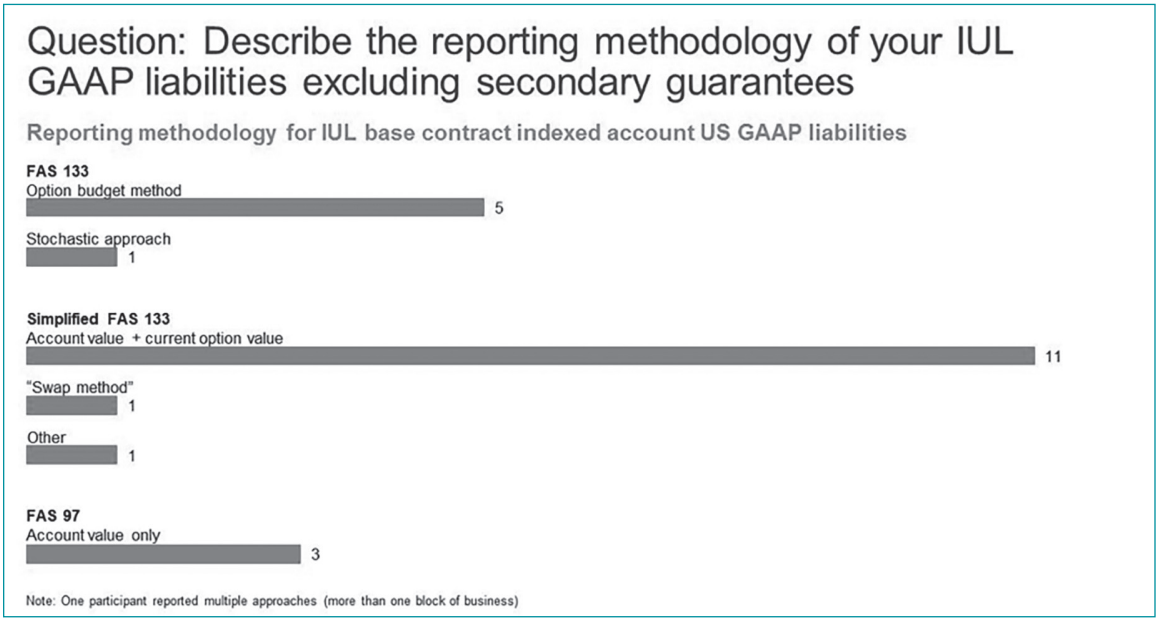

Exhibit 1

Only six participants out of 21 claim to use a full-blown FAS 133 approach. That is, more than 70 percent of participants use some form of simplified approach. Among the simplified approaches, the "account value plus option value method" was reported as the most frequent. Under this method, the ED only reflects the option value associated with the current indexed crediting term.

We believe that the prevalence of simplified approaches is driven both by the lack of IUL-specific guidance and the complexity of full-blown FAS 133 methods. The complexity and wide range of full-blown FAS 133 approaches were confirmed by the survey and are discussed further below.

FULL-BLOWN FAS 133 APPROACHES HAVE NOT CONVERGED

Several additional survey questions focused on full-blown FAS 133 methodologies. The main areas of variation in

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practice were summarized in the table below. The last column highlights implications relating to methodology choices; these implications are not exhaustive and there are many more aspects to consider.

Table 1 – discussion of full-blown FAS 133 methodologies

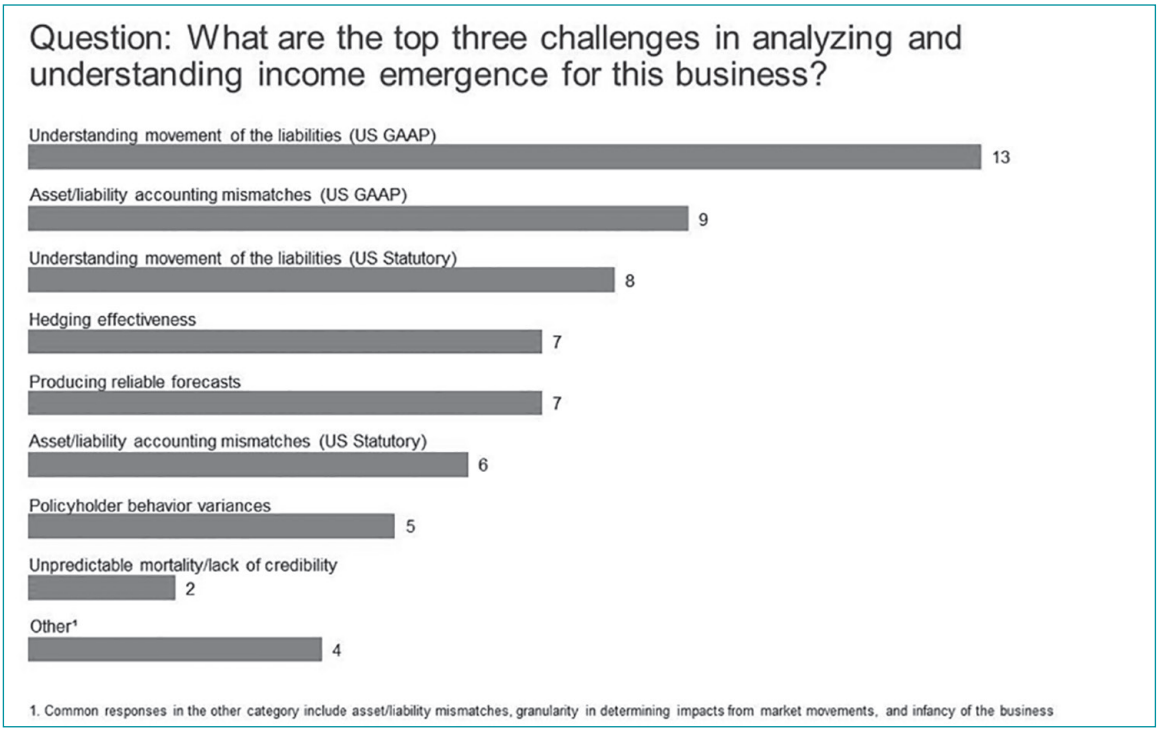
AREA OF VARIATION	PRACTICES REPORTED	IMPLICATIONS OF METHODOLOGY CHOICE
Inclusion of future premium in the run(s) supporting ED excess cash flows.	• Future premium can be included or excluded. • Both approaches were used by participants.	• Excluding future premium will reduce the projected fund value and likely cause early lapses; the time horizon for the excess cash flows will be limited, reducing the ED. • If future premium are excluded, actual new premium will create a variance on the ED associated with prior premium.
Approach to calculate guaranteed cash flows.	• Notional approach (e.g., track a separate guaranteed account) versus a separate projection to obtain guaranteed cash flows. • Both approaches were used by participants.	• If a separate projection with zero index growth is used, the policy funding and policyholder behavior in the "guaranteed run" will deviate from the "best estimate run."
Cash flows included in ED	• Liability cash flows (e.g., death benefits, surrender benefits, partial withdrawals) were included by all participants. • Account value-based charges were included by some participants.	• The cash flows included in the ED will impact the unwinding of the liability and resulting income emergence.
ED discount rate	• Treasury rates plus non-performance spread was the most common. • Other approaches included Treasury rates, swap rates, or swap rates plus spread.	• Choice of discount rate and basis for non-performance risk spread impacts the volatility of the ED.
Premium bifurcation	• Account for premium payments separately. • Group premium payment for purpose of bifurcation. • Pro-rata approach—not typically done in practice.	• Complexity of valuation calculations and underlying data feeds.
Host accrual	• Some but not all participants recalculate the host value as the present value of guaranteed cash flows. • The host accrual rate is restated either at each valuation period, at the end of a credited term, or upon payments or withdrawals.	• Methodology can impact the "smoothness" of the host accrual.

In summary, and as expected when the survey was initiated, full-blown FAS 133 approaches have not converged.

US GAAP CREATES THE MOST SIGNIFICANT FINANCIAL REPORTING CHALLENGE FOR IUL

Despite the frequent use of simplified FAS 133 approaches, most participants mentioned US GAAP income emergence-related issues as being their most significant financial reporting challenge:

Exhibit 2



On another survey question, nearly all participants reported model complexity, largely due to US GAAP, as being a significant barrier to producing quality financial reporting results.

SUMMARY

IUL US GAAP financial reporting is complex and IUL writers are facing significant challenges related to methodology, modeling and analysis of results. In absence of IUL-specific guidance from FASB and with the rapid growth of the market, we expect the debate on implementation approaches to continue and to gain greater attention. ■

ENDNOTES

1 US GAAP guidance can be found in ACS 944 & 820, formerly SFAS 133 and SFAS 157. For simplicity, this will be referred to as FAS 133 in this article.

2 Defined as using bifurcation and using a discounted cash flow method for the ED (option budget method or stochastic method).

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