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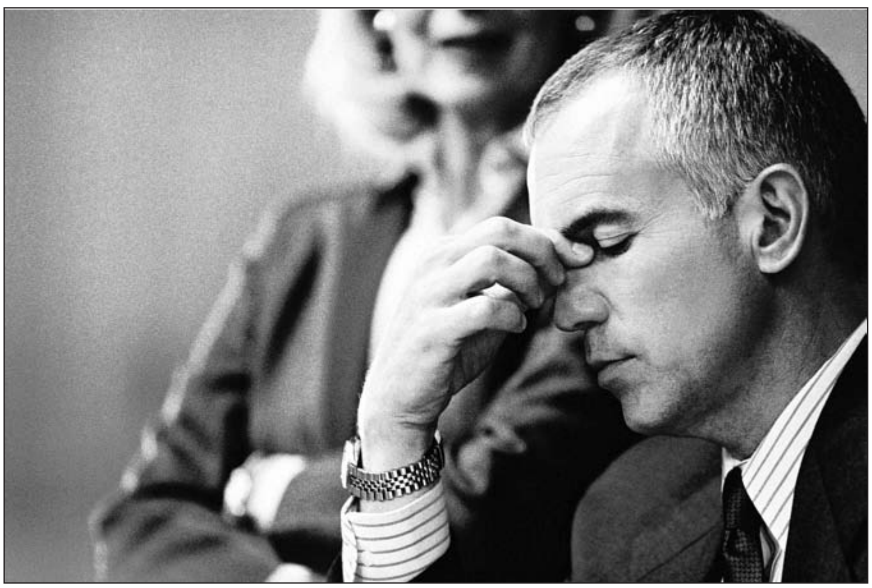
Israeli DAC Accounting—
Improvisation Doesn't Always Work
by Alan Dubin

Israelis are excellent improvisers. Even in the mundane world of life insurance accounting, the Israeli Commissioner's Office improvised a creature known locally as DAC accounting. Since 1999, Israeli companies have been reporting using Israeli DAC. This article will describe the Israeli DAC and its ramifications on the Israeli market.

Background
There is no legal standard for reserves in Israel. For the traditional endowment to 65 policies, all companies held net-level reserves, with a Zillmer allowance for initial expenses. The Zillmer allowance is similar to the CRVM allowance; however, the initial expense is a flat amount per thousand (about 30 per thousand of insurance) irrespective of the actual premium for the policy. In the late 80s, a simplified fixed-premium universal life policy called *Adif* supplanted the traditional endowment policy. Due to the high surrender values of these policies, the Zillmer allowance thereon was quite small—only 15 to 20 percent of the first-year premium.



Until the late 1990s, rates for most covers were uniform and fixed by the Commissioner's office. Companies competed for business by offering ever-higher agent compensation. Due to the ever-increasing compensation, new business became, at best, marginally profitable. New business strain lowered the profits generated by older in-force policies, which were very profitable in the later durations.

Israeli DAC
The motivation for Israeli DAC is unclear. Some say that it was to increase reported profit and tax revenues. Some say that is was a way to "modernize" and "internationalize" Israeli accounting. Some say that it was a method to limit agent compensation levels, even though it had the opposite effect!

The commissioner's office was faced with the task of introducing a new accounting system, which could be easily and immediately implemented and could serve for both supervisory and stockholder reports. This was the final product:

1) Acquisition expenses are capitalized at issue and were amortized on a straight-line basis over 15 years from policy issue.

2) The capitalized acquisition costs are fully written off for a lapsed policy.

3) No changes were made in the computation of policy reserves.

4 For tax and minimum capital purposes, DAC is amortized over four years from time of incurral, faster amortization than for reporting to stockholders.

5) A conversion for in-force policies to Israeli DAC as of the commencement of the new accounting methodology was not carried out.

6) For certain policies, the policy's surrender value is the floor on the net reserve (policy reserve less DAC).

7) A company's actuary annually certifies that the recoverability of DAC asset under best-estimate assumptions with provisions for adverse deviation.

The great advantage of this system is its simplicity and ease of implementation. Companies simply had to measure their acquisition expenses, defer them at incurral and write them off on a straight-line basis. The main complications were in determining acquisition expense and allocating non-commission expense to policies so that the DAC could be written off upon policy lapse. This was basically an exercise for the accountants and computer people; actuaries were really not needed except to determine recoverability. Less than one year of lead-time was provided to the industry for the DAC conversion, made possible due to the simplicity of the system.

Let's examine what happened under Israeli DAC reporting. Despite the initial opposition, the industry came to appreciate Israeli DAC very quickly. As there was no restatement for in-force business, the in-force business gave off large profits, as most of the expenses were previously expensed at issue. At the same time, actual acquisition expenses on new business were deferred. This led to a large and immediate increase in reported profit. This, in turn, made company management very happy. During the late 1990s, the Israeli stock market was booming under the influence of the expanding high-tech bubble and the hopes for peace under the Oslo accords. Insurance profits and stock prices increased with the double injection of added investment profits and Israeli DAC.

Companies continued to compete largely on agent compensation. The DAC system allowed for increased agent compensation without the accompanying bottom line hit as the compensation cost was deferred.

Then came the turn around. On the political front, the *Intifada* started in September 2000. At the same time, the high-tech bubble burst. The year 2001 brought the September 11 disaster and the subsequent jolt to the world economy. During 2001 and 2002, the economic downturn in Israel triggered by all these events was sorely felt by the insurance industry. By 2002, investment profits declined dramatically. New premium income decreased and persistency dramatically worsened with the decreased economic activity and increased unemployment. There are stories of policyholders surrendering their policies to pay monthly bills.

Israeli DAC surely didn't help the situation for the insurance companies. Life insurance profits were further decreased by the DAC amortization mechanism. Straight-line amortization of the DAC is simply too fast. The lapse engendered DAC write off was compounded in severity by straight-line DAC amortization for the policies remaining in-force. Under U.S. GAAP, both interest and persistency are factored into the DAC amortization, while under Israeli DAC neither element is taken into consideration. I predict that within several years the amortization of DAC will be larger than the increase in DAC from new deferrals, with DAC providing a negative contribution to profit.

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For minimum capital standards, the DAC is amortized over four years from the date of incurral of the expense. This is really a very fast write off. Companies that depended on DAC to meet the capital requirements found that there is not too much of it left after several years.

There are more problems in store for DAC. The insurance commissioner has opined that agent compensation and the expenses charged in life insurance contracts are too high. New regulations will require much-improved contracts with lower expenses and commissions. Agents will have good reason to convert in-force policies to the new lower expense policies. This will accelerate the DAC write off and will lead to further decreases in reported profits.

In summary, the world and the Israeli economy's downturn has adversely impacted the life insurance profitability. This would have happened under any reporting system. However, the improvised Israeli DAC accounting system, instead of providing a better measure of company profitability, exaggerated profits in the early years of its implementation and is currently exaggerating losses during difficult economic times. ☐

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