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International Implications of SOP 03-1

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Editor's Note: This is the second article devoted to unique international accounting issues. International News *solicits from its readers additional articles on international accounting issues or comments on articles published here.*

Summary

The American Institute of Certified Public Accountants (AICPA) published guidance for nontraditional long-duration contracts and for separate accounts in their first Standard of Practice issued in 2003 (SOP 03-1). Being a United States organization, they naturally focused on issues germane to the U.S. marketplace. This article will share some insights on how SOP 03-1 uniquely impacts foreign companies that report financial results in accordance with U.S. generally accepted accounting principles (U.S. GAAP).

The SOP gives detailed guidance on accounting for separate accounts and this resulted in somewhat surprising results in some countries. Guidance on whether contracts qualify as being insurance was quite relevant to companies seeking to keep traditional insurance accounting under new International Accounting Standards (IAS). Similarly, efforts on reserving for insurance guarantees like guaranteed minimum death benefits helped companies prepare for the European CFO guideline requirements.

Read on to share the authors' experience implementing SOP 03-1 in a number of countries.

Separate Accounts

Separate accounts enjoy a simple treatment in GAAP financial statements. The separate account is held as a single asset and an equal single liability in the balance sheet, while investment results are excluded from the income statement. For unit-linked and other products to qualify for this treatment, four criteria must be satisfied (see shaded box on page 9).

Prior to SOP 03-1, foreign companies frequently classified unit-linked contracts using only the last two criteria, so legal opinions were requested during the adoption of the statement in a number of countries to evaluate whether a separate account satisfied the first two criteria. Unfortunately, a number of countries do not provide for the legal insulation of separate accounts and some of the countries where separate accounts had to be reintegrated into the general account for GAAP include:

- Czech Republic
- France (some contracts)
- Italy
- Japan
- Liechtenstein
- Netherlands
- Poland
- Slovakia
- United Kingdom

If any of the criteria are not met, the assets are commingled with the assets of the general account and valued according to their SFAS 115 classification. If the assets backing the unit-linked contracts were classified as "trading" there is usually little impact on either equity or income. However, if any other asset classification is chosen, there could be a mismatch between asset income and liability income and a corresponding offset in other comprehensive income.

Qualification as Insurance

Paragraphs 24-25 of SOP 03-1 provide more explicit guidance on whether a contract provides "significant mortality or morbidity risk" and thus is accounted for under SFAS 97 instead of SFAS 91 (investment contracts).

Paragraph 11 of *SOP 03-1* criteria required for separate account treatment:

1) It must be a legally recognized separate account.
2) It must be legally insulated from the General Account.
3) It must invest as directed by SA contract holder.
4) All investment performance must be passed through to the contract holder.

"The determination of the significance of mortality or morbidity risk should be based on a comparison of the present value of future excess payments to be made under insurance benefit features…with the present value of all amounts expected to be assessed against contract holders…

In performing the analysis, an insurance enterprise should consider both frequency and severity under a full range of scenarios that considers the volatility inherent in the assumptions…"

There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly with capital markets volatility.

Examples of products that qualify:

1) An Italian equity-indexed product that pays the single premium improved with interest at maturity plus 50 percent of the appreciation in the DAX50 stock index that also guarantees a return of premium at death. In this case the single premium for the death benefit (1 percent) is significant when compared to the total front-end load (10 percent).

2) A French single premium unit-linked product that guarantees a return of premium at death. This qualifies under the rebuttable presumption that the benefit "would vary significantly with capital markets volatility."

Following is an example of a product that fails to qualify:

1) A United Kingdom unit-linked contract that pays a death benefit equal to 101 percent of the account value at death since the value of the benefit is insignificant when compared to the value of fees to be collected.

Note that there was a significant incentive for European companies to qualify products as having significant mortality risk since this permits them to continue existing local accounting treatment under IFRS 4 for their 2005 International Accounting Standard compliance.

Additional Benefit Liabilities

The most common additional benefit found by the authors has been the guaranteed minimum death benefit (GMDB), followed by the guaranteed minimum income benefit (GMIB). Guaranteed minimum accumulation benefits (GMABs) are relatively rare.

There is a rebuttable presumption that a contract has significantly mortality risk where the additional insurance benefit would vary significantly with capital markets volatility.

Guaranteed Minimum Death Benefits (GMDB)

GMDBs benefits are frequently quite simple, involving just a return of premium at death or upon occurrence of other specified events (for example, the unit-linked version of the PEP product in France which pays benefits if unemployed, injured, etc.).

Paragraphs 26-28 of SOP 03-1 specify how additional liabilities should be calculated. In simplified terms, a constant proportion of Expected Gross Profits (EGP) is contributed to the reserve, which increases with interest and decreases as claims are paid. The additional liability is much like a constant loss ratio reserve in health insurance.

GMDB liabilities were somewhat of a non-event in markets where products are fully funded by front-end loads (deductions from the original single premium), since it simply required bifurcating the front-end load into the benefit liability and the residual deferred profit liability. Markets with products funded from asset-based fees frequently required more effort since companies frequently held no explicit reserve for these benefits.

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Guaranteed Minimum Income Benefits (GMIB)

Deferred annuity contracts in some countries, such as Italy, have guaranteed annuity purchase rates based upon the statutory life insurance mortality table used to value death benefits. Regulators (such as ISVAP in Italy) may require insurance companies to hold an additional statutory liability when contractual annuity purchase rate guarantees are more favorable than current purchase rates. The question then arises whether the statutory GMIB reserve can be used for GAAP purposes and the answer requires a careful review of three key assumptions:

1) Discount rate – GAAP best estimate may be higher than a conservative statutory valuation rate.
2) Annuity election rate – election rates are low, frequently in the 2-4 percent range, since customers may not understand the value equation.
3) Annuitant mortality – there is a tendency for regulatory conservatism.

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The greatest challenge is with the third assumption, expected annuitant mortality, since this is rarely studied. The local actuary may wish to refer to the SOA's Table Manager[1] in this case to develop a reasonable estimate of annuitant mortality. In the Italian case, the following logic was followed:

- Recent Swiss retiree mortality was similar to U.S. retiree mortality, so one could conclude that neighboring Italian mortality would be similar to U.S. mortality.
- A comparison of mortality improvement from Italian statutory mortality tables over the period from 1971 to 1992 to a U.S. annuitant mortality projection scale indicated that the U.S. projection scale was reasonable.
- A comparison of U.S. individual annuity mortality against group annuity mortality indicated that individual selection increases the cost of an immediate annuity about 5 percent.[2]

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Applying the mortality assumption derived in this manner and a realistic discount rate led to the conclusion that unique "best estimate" GAAP assumptions produce additional reserves lower than statutory reserves.

Sales Inducements

These include a day-one bonus, persistency bonus, enhanced crediting rate bonus, and should be included as a liability over the period for which policyholders must stay in force to be eligible. If the criteria are met, the bonus is deferred and amortized using the same methodology and assumptions used to amortize DAC. The unamortized sales inducement is booked as an asset separately from DAC and is called the Deferred Sales Inducement. The amortization is to be recognized as a component of benefit expense.

Sales inducements are not very common in many international markets.

Conclusion

The introduction of SOP 03-1 was a timely event for companies that would later need to comply with IAS and European CFO guideline requirements. It clarified some previous ambiguous U.S. GAAP guidance and covered products and product features that had not existed when SFAS 97 had been issued. Implementing it required substantial effort by a number of companies and their auditors.

The failure for unit-linked products to qualify for separate account treatment is a telling example of the need for actuaries to put aside preconceived notions and carefully evaluate the local situation before attempting to comply with U.S. GAAP accounting standards.

Overall, SOP 03-1 has helped companies better measure and manage risks. Companies subject to either US GAAP or European CFO guidelines may find that increased senior management understanding of implicit guarantees may achieve a competitive advantage over local competitors that are not fully cognizant of risks that they are taking. ☐

1) The SOA Table Manager is available for free at the SOA's Web site *www.soa.org*. Search for "table manager" to find it

2) Report of the Individual Annuity Experience Committee, "Mortality under Individual Immediate Annuities, Life Income Settlements, and Matured Deferred Annuities between 1976 and 1986 Anniversaries," Transactions of Society of Actuaries 1991-92 reports