SOCIETY OF ACTUARIES

Article from:

# The Actuary

July/August 1988 – Volume 22, No. 7

# FAS No. 97 Brings Sweeping Changes

by Mark D. J. Evans

Recently the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts and for Realized Gains and Losses from the Sale of Investments. This statement contains wide-sweeping changes to the preparation of GAAP financials for insurance companies. This includes GAAP reporting for universal life contracts. The focus here will be on the ramifications of the interest rate FASB has decided to use to amortize deferred acquisition costs.

The FASB chose to use the interest rate credited to policyholder account values to amortize deferred acquisition costs as opposed to using the interest rate assumed to be earned on the assets invested to support policyholder account values. Because of this choice, FASB has introduced an inconsistency between the methods used to report financial statements for universal life and the techniques required for recoverability testing. The FASB method causes this inconsistency because it creates artificial earnings by assuming that money "invested" to support policyholder account values earns a greater rate than the money "borrowed" to repay the acquisition expense.

To study the quantitative effects of this, a simple model was constructed. The model projects a single 10,000 face amount policy for 25 years. The interest credited to the policyholder account value is 6% while it was assumed that assets earn 8%. The policyholder is assumed to pay an annual premium of 100 at the beginning of each year. The results from the projection were then used to generate cash flows and to emulate the FASB model. The projections were also used to study a modified version of the FASB model where the deferred acquisition cost was amortized using the earned rate rather than the credited rate. The model assumed acquisition expense of 190.

The resulting cash flows discounted at a 6% interest rate resulted in a present value of −85.67. The cash flows discounted at an 8% interest rate resulted in a present value of −27.89. This demonstrates that the product is not profitable and that it is inappropriate to defer the entire 190 acquisition expense. However, under the FASB method, the present value of FASB margins at 6% is 190.90, incorrectly suggesting that the entire acquisition cost can be deferred. Also according to the FASB method, slight profits are produced. This is on a product which we have previously seen to be a losing proposition by a significant amount. The so-called profits that this model generates have slightly positive present values at both 6% and 8% (.90 and .75 respectively), despite the fact that we have seen that the product actually will produce significant losses on an economic basis. Finally the modified FASB method with deferred acquisition costs amortized at the earned rate of 8% produces a present value of margins at 8% of 162.11. This suggests correctly that the entire 190 of acquisition expense cannot be deferred. Note that the 27.89 that cannot be deferred exactly corresponds to the −27.89 present value of net cash flows at 8%. Thus, we can see that if FASB had used the earned rate for discounting margins and amortizing deferred acquisition costs, the model would have been consistent with impairment tests and profitability.

It has been argued that the liability grows at the credited rate so that the asset should grow at the credited rate also. Since the liability has been set equal to the policyholder account values by the FASB method, it is true that mechanically the liability grows at the credited rate. But the FASB method assumes that the investments backing policyholder account values earn interest at the earned rate. This produces the interest margin used to amortize the acquisition expense.

Thus to be consistent, interest paid on the expense asset should be the earned rate, not the credited rate. This inconsistency between assumptions as to the interest rate earned on the funds supporting the liability and the interest rate earned on the deferred acquisition cost asset is what, in fact, generates the inconsistency in the FASB method and recoverability testing. The FASB has recognized this inconsistency in paragraph 27 of Standard No. 97 which states, "The provisions of Statement 60 dealing with loss recognition (premium deficiency)...shall apply to...universal life contracts addressed by this statement."

A complication not considered by Standard No. 97 involves a situation in which there is a corridor interest rate. For example, some universal life contracts pay a lower interest rate on the first 500 or 1,000 of fund value. Statement No. 97 does not prescribe a method for handling such a situation.

To summarize, the FASB method can produce a present value of margins which significantly exceeds the acquisition expense deferral that can actually be supported. This produces a material difference from impairment test results.

*(Ed. Note: Tables showing the detailed calculations concerning the illustration referred to in this article may be obtained by writing to* The Actuary, *Society of Actuaries, 500 Park Boulevard, Itasca, IL 60143.)*

**Mark D. J. Evans is Assistant Vice President and Actuary of Capitol Holding Corporation.**

*Guaranteed Returns cont'd.*

constitutes a significant advance in preserving the long-term character of life insurance and annuity products.

With the availability of the NAIC model regulation, state insurance departments can move speedily to authorize products that are safer, easier to supervise and better for consumers. The lesson of Forster's "tragedy of the commons" is that individual gain and collective risk are a disastrous combination in the absence of careful regulation. Surely we need not risk a large-scale insolvency to drive that lesson home.

[1]W.F. Lloyd, *Two Lectures on the Checks to Population*, Oxford University Press (Oxford, England, 1833).
[2]Garrett Hardin, "The Tragedy of the Commons," *Science* (Vol. 162, December 13, 1968), p. 1243 ff.
[3]Connecticut has adopted regulations governing annuities only, while New York has enacted legislation covering both annuities and life insurance required, along with full disclosure of commissions and expenses.

**Donald R. Sondergeld is Senior Vice President and Chief Actuary, Hartford Life Insurance Companies. He is a member of the SOA Board of Governors and the Committee on Life Insurance Company Valuation Principles.**