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Using Financial Reinsurance to Address GAAP Earnings Volatility

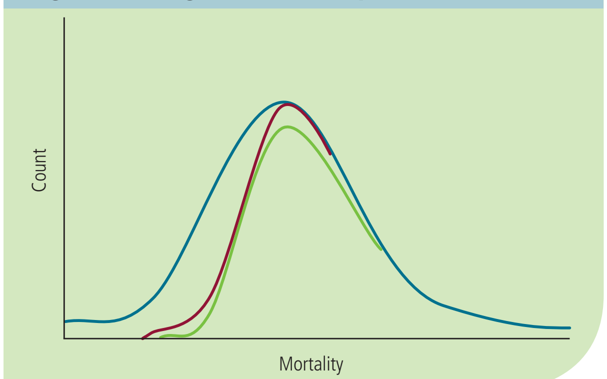
By Scott Boug, FSA, MAAA, CFA
Senior Vice President, Financial & Capital Reinsurance

Discussions around financial solutions usually involve programs to manage peak redundant reserves associated with XXX/AXXX compliance. Financial reinsurance is an effective tool that helps carriers manage both the mortality risk of the portfolio and the statutory reserves and capital that arise from regulations such as XXX. But reinsurance solutions also help carriers manage other areas of their business.

XXX and AXXX solutions involve addressing challenges associated with strain created by statutory accounting principles. The use of financial solutions can extend into a company's GAAP accounting obligations as well. Many companies today are looking to manage their inforce blocks more actively. Today it is quite common for us to interact with company executives with "inforce management" in their titles. Many of these executives were present at the latest ReFocus conference.

One area of concern for companies reporting on a GAAP basis is in managing a predictable unlocking of deferred acquisition costs (DAC).

Figure 1 – Higher Shock Lapse = Lower Profit



Companies routinely factor in significant end-of-level period lapses for their term business, with the lapses disproportionately affecting the best risks (red line). Experience for many companies, however, has underestimated the shock lapse (green line).

Pressing market and business considerations are driving inforce managers to consider their reserve and DAC management strategies:

- Interest rate assumptions are falling short as Treasury rates remain at record-low levels. The challenge is aggravated by statutory requirements to hold reserves and capital in highly liquid assets (e.g., bonds and other cash equivalents), whose yields create increased strain
- The post-level term shock lapse associated with level premium term so far has exceeded many companies' expectations. In addition to potentially losing a larger share of the better risks than anticipated, this higher lapse rate also reduces the aggregate profits associated with this business. Fewer policies inforce means fewer policies on which to make a profit (Figure 1)
- In contrast to the shock lapse rate, mortality experience for many companies appears to be holding steady, creating a profit stream which would make a financial solution more feasible to execute

DAC, Unlock and Its Effect on Earnings

Often left unaddressed is the effect of these issues on the unlock of deferred acquisition costs (DAC).

DAC is an asset that life insurers who report earnings on a

SCOR Global Life Americas

Charlotte
101 South Tryon Street
Suite 3200
Charlotte, NC 28280

Kansas City
11625 Rosewood Street
Suite 300
Leawood, KS 66211

Minneapolis
45 South Seventh Street
Suite 1850
Minneapolis, MN 55402

www.scor.com/SGLA

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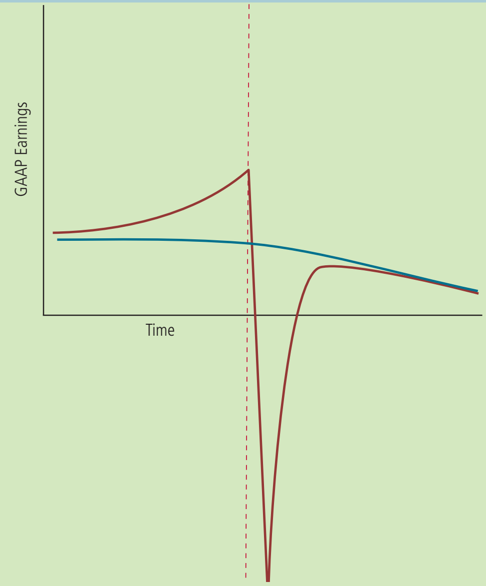
GAAP basis carry on their books and amortize as an expense over a set schedule. As companies unlock DAC, the value of the asset declines. Companies model their amortization pattern to 1) attempt to coincide with change in the business to which it is tied and 2) to try to create some certainty around the release. Even small changes such as variance in expected lapse or actual-to-expected mortality (A/E) can cause significant changes in the pattern and materially affect a company's reported earnings.

Actuaries can implement DAC to a block of business in several ways. The most common approach attaches DAC to a policy based on the policy's size, using constant ("unitized") assumptions across the block. The accountant or actuary can quickly determine how changes to the policy (lapse, conversion, claim, etc.) affect DAC.

The shock lapse has a profound impact on DAC, which can create substantial earnings volatility and short-term deterioration. As DAC is usually determined using the unitized approach, any increase in the number of lapses requires a proportionate decrease in DAC. As the shock lapse usually results in a dramatic reduction of inforce policies, the DAC released can be material.

If a company's lapse and mortality experience follow its assumptions, a stock company can forewarn and explain such volatility in its quarterly reports. However, we have observed a "perfect storm" for DAC, which can exacerbate the shock lapse effect. Specifically, lapse experience over the level period has been lower than expected (more policies remaining inforce). As a result, we have not seen the level of amortization that many companies expected. This creates a swell in the DAC asset until the end of the level period. The shock lapse, which is higher than expected, then forces the company to write off far more of the DAC asset at a point in time than originally anticipated. The result is a much bigger loss in the DAC asset than was expected (Figure 2).

Figure 2 – DAC Amortization "Perfect Storm"



The blue line represents a company's expected GAAP earnings for a single-issue year cohort of 20-year level term policies. At the end of the level period, the company experiences a large drop in the asset value. If level-period lapses were lower than expected, the effect can be much worse. (For illustrative purposes only.)

Options to Address DAC Volatility

Overall, once carriers decide on a DAC approach they must adhere to that approach even if the effects create choppy releases.

But an insurer does have options. Perhaps the simplest, but by no means necessarily the ideal, alternative is to sell the block. The buyer assumes any assumption risk, and the insurer eliminates the potential volatility associated with the block. Of course, the insurer is also selling any future profit streams, which could be quite accretive.

A potentially better alternative is to enter a coinsurance agreement whereby the insurer cedes 51 percent or more of the business to a reinsurer. Under GAAP terms, this would constitute a "sale," providing all the benefits of a divestiture while still allowing the insurer to participate in future profits.

DAC Must Be Amortized

Regardless of the three approaches mentioned above (retention, sale, reinsurance), we still must note that the DAC asset needs to be released eventually. If a company retains the business, the write-down likely will be a slow bleed, potentially creating earnings volatility for the foreseeable future. As we all know, the investment community dislikes earnings uncertainty and volatility. Purely from this perspective, then, this is the least appealing option.

A sale generally results in an immediate unlock of all residual DAC attributed to the block: the insurer should not be able to carry deferred expenses related to a business it no longer owns. From an earnings perspective, this can be quite painful to the bottom line. However, experience indicates that, if properly explained and made transparent to stakeholders, such an approach actually can benefit the carrier in the long term. Volatility and uncertainty have been eliminated.

The coinsurance approach may provide a life insurer with more flexibility in scheduling the release. The degree to which the carrier can more effectively manage DAC volatility likely will be determined by the treaty terms.

SCOR has collaborated with a number of clients in developing solutions to help manage the financial challenges of writing new business and managing inforce. This becomes especially important to insurers when market forces alter the assumptions under which the products originally were designed. If you would like to explore options available for more effective inforce management, please feel free to contact your account executive or me. ∞