Caveat Emptor

New BOLI SVP Features May Present Undesirable Accounting Implications

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Preface

From the late 1990s to 2008, over $60 billion of notional Stable Value Protection (SVP) was underwritten within Bank-Owned Life Insurance (BOLI) by about a half dozen leading providers. This all came to an abrupt end in 2008. As a result of the financial crisis, these third-party SVP providers pulled back from the market and several ultimately ceased writing additional business altogether.

This displacement left a vacuum in the market, and it took the industry several years to reinvent SVP solutions to begin filling the void. In many instances, insurance companies that underwrite BOLI contracts have endeavored to create solutions for their own products.

Presently, there are several companies looking to issue SVP features for Variable Separate Account (VSA) BOLI, and there appears to be significant interest by banks to evaluate and implement these solutions. These new SVP designs vary widely from one another. As noted in a recent publication by Dixon Hughes Goodman, SVP contracts are highly complex, bespoke agreements that require careful scrutiny on a number of fronts.[1]

In this paper, we delve into some of the key accounting considerations of which BOLI owners should be mindful when evaluating potential SVP features. Buyers must beware – SVP providers generally offer no assurances as to the accounting treatment of the SVP features they offer. The implications of misunderstanding and mischaracterizing the GAAP treatment of an SVP feature could be severe.[2]

1 BOLI Stable Value Protection Market in Process of Transformation (https://www.dhg.com/resources/publications/article/2342)

2 In 2003, Washington Mutual restated its carrying value for BOLI after an audit found that certain components of its policy values were not realizable upon surrender. This resulted in a $73 million charge. See Washington Mutual Inc. 10-Q 09/30/2003

High-Level Overview of Accounting Requirements for SVP

Under FASB ASC 325-30, all BOLI contracts are accounted for at their net realizable value (i.e., the amount that can be realized upon surrendering the contracts).

Broadly speaking, there are three approaches that can be used to provide SVP:

1. The contract value (often referred to as "book value") can be paid out within one year of surrender;
2. The book value can be paid in periods that extend beyond one year from surrender (subject to GAAP requirement to discount the future flows to reflect a present value); and
3. The book value can be paid in periods that extend beyond one year from surrender, but seek to employ a GAAP exception from the requirement to discount the future flows (these are often referred to as "crawl-outs").

In 2006, FASB clarified the accounting treatment for extended payout provisions in a meaningful way.[3] It specified that, in general, amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy must be discounted.[4] However, FASB provided a narrow exception to the need to discount amounts that are recoverable if two conditions exist:

1. Contractual restrictions on the ability to surrender a policy exist (i.e., presumably, the insurance policy must stay in force); and
2. The holder of the policy continues to **participate in the changes in the cash surrender value as it had done before the surrender request** (emphasis added).[5]

The balance of this paper briefly addresses each approach to providing BOLI SVP. In our view, the first two approaches are relatively straightforward in principle, though certainly not lacking in their own evaluation considerations. However, we then focus primarily on crawl-out solutions aiming to avoid the need to discount future cash flows, many of which appear highly vulnerable if put to any meaningful level of scrutiny.

3 FASB EITF 2006-5
4 FASB ASC 325-30-35-4
5 FASB ASC 325-30-35-6

Book Value Payments within One Year from Surrender

FASB's requirement to discount amounts received upon surrender only apply if the amounts extend beyond one year from surrender; it is clear that book value (BV) payments made within one year are not required to be discounted.

It bears repeating, however, that BOLI SVP contracts are highly complex contractual agreements. It is advisable to perform a rigorous review of all stable value agreements purporting to pay BV within a year to confirm such contracts do not include contingencies that might call the accounting treatment into question.

Prior to the financial crisis, most third-party SVP providers offered contracts that either paid out 180 days after a surrender or 360 days after surrender. The contracts generally mandated that post-surrender the investment portfolio would be converted to a Treasury or money market portfolio. If the SVP provider had any loss exposure, a feature within the crediting rate formula would typically result in a floored, zero percent crediting rate. As such, any growth in the market value (MV) post-surrender essentially inured to the SVP provider to reduce its loss exposure. At the contractual payment date, any difference between the MV and the book value was a payment obligation borne by the SVP provider. Understandably, the 360-day payouts were offered at a slight price concession to the 180-day payouts.

Subsequent to the financial crisis and corresponding with the prolonged low interest rate environment, SVP providers realized that there may be little, if any, opportunity to reduce loss exposures within a one-year period. This realization, in conjunction with its impact on long relied-upon risk modeling, was at the heart of the exodus of third-party SVP providers following the financial crisis.

At present, it seems unlikely that any third party will be willing to write a commercially viable SVP contract with a 360-day (or shorter) payout to a new BOLI purchaser. However, if sufficient contractual impediments to disintermediation can be agreed upon, it is possible that seasoned BOLI owners could procure this type of SVP. Contractual impediments the SVP provider would likely insist upon include:

1. The requirement to surrender other BOLI contracts prior to surrendering the BOLI contract subject to the new SVP;
2. Requirements that the policyowner be in strong financial position (these provisions can take a number of forms); and
3. Provisions that allow the SVP provider to terminate the contract under numerous scenarios/conditions (i.e., situations the SVP provider views as increasing the risk of policy surrenders). These include changes in the tax treatment of the policies, legal/regulatory compliance failures of the policyowner, and changes in accounting treatment.

BV Payments Extended Beyond One Year – Subject to Discounting

As per FASB ASC 325-30-35-4, amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy generally must be discounted to reflect a present value in accordance with FASB topic 835.

As per FASB ASC 835, the present value of the payment(s) must be calculated using interest rates prevailing at the time of surrender. The determination of an appropriate discount rate can be a complex and challenging task. FASB describes the objective as being an attempt to approximate the rate for a note that would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions.[6]

Since BOLI is widely considered to be an investment transaction, a similar standard that may be deemed applicable is to determine the "fair value" of the post-surrender payment(s). The determination of a fair value frequently hinges on market-observable transactions, with the objective being to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date.[7]

Fully detailing the considerations and issues that must be taken into account when discounting an extended payout is beyond the scope of this paper. However, some key considerations include:

1. Is the post-surrender interest rate a market-based rate?
    a. If not, an appropriate discount rate must be determined, and the post-surrender cash flows must be discounted at the appropriate discount rate.
    b. If the interest rate is a market rate, what support is available to establish that it is a reasonable, fair value rate of interest?
2. What spread, relative to matching duration Treasury rates, do the payment(s) generate? Again, does such rate of return represent a reasonable, arm's-length rate of interest?
3. Is the rate likely to be reasonable under various economic and interest rate environments?
4. Are the contractual impediments so strong as to make it nearly impossible to qualify for the book value payment upon a surrender?

6 FASB ASC 835-30-10-1
7 FASB ASC 820-10-05-1B

BV Payments Extended Beyond One Year – Exempt from GAAP Discounting Requirement

As noted above, FASB provides a limited path to avoid needing to discount amounts received in periods beyond one year from surrender. FASB ASC 325-30-35-6 states (emphasis added):

> A policyholder shall not discount the cash surrender value component of the amount that could be realized under the insurance contract when contractual restrictions on the ability to surrender a policy exist, **as long as the holder of the policy continues to participate in the changes in the cash surrender value as it had done before the surrender request.** If, however, the **contractual restrictions prevent the policyholder from participating in changes to the cash surrender value component, then the amount that could be realized under the insurance contract at a future date shall be discounted** in accordance with Topic 835.[8]

Policyholders must take meticulous care to ensure that the post-surrender participation in changes in the cash surrender value is the same as it had been before the surrender request (we refer to this as the "*unchanged participation*" standard). Put another way, if the post-surrender changes in cash surrender value are demonstrably different than the changes that would transpire in the absence of a surrender, then it is difficult to argue that the participation is "as it had [been] before the surrender request."

Many provisions that are triggered upon surrender clearly alter the policyholder's participation in the changes in cash surrender value and likely jeopardize the policyholder's ability to avoid discounting the payouts to reflect a present value. These include:

- Provisions either requiring the pre-surrender portfolio(s) to be effectively de-risked (e.g., allocated or repositioned to short-duration investments) or providing the SVP provider the right to require such changes to the investment portfolio(s);
- Modifications to the crediting rate (e.g., changing an input to the formula to amortize differences between MV and BV more rapidly, removing or modifying incremental yield, adding additional variables to the formula, or condensing the amortization period of up-front expenses); or
- Changing the frequency of crediting rate resets (e.g., allowing the SVP provider to reset the rate daily instead of whatever frequency applied pre-surrender).

8 FASB ASC 325-30-35-6

Because each of these provisions either worsens the policyholder's participation in cash surrender values (i.e., post-surrender) or has the express potential to do so, policyholders will find it challenging to demonstrate that their participation in the cash surrender value is not subject to change. More likely than not, SVP solutions containing any similar provisions will, when subjected to any degree of scrutiny, be required to be discounted to reflect a present value.

The absence of changes in provisions upon surrender does not assure that the policyholder will continue to participate in the changes in the cash surrender value as it had done before the surrender request. Whether the policyholder continues to participate in changes in cash surrender values post-surrender as it had prior to surrender can, and, in our view, must be proven empirically. This is so because contractual provisions can be constructed in a way that, despite the fact they remain unchanged when surrenders occur, the policyholder's participation in cash value changes (i.e., worsens).

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As just one example of this dynamic, the methodology of making book value payments can have a material impact on participation.

Empirical Analysis – Methodology of BV Payments

Determining the manner in which the book value payments are made and what impact, if any, the payments have on the ongoing participation in the cash surrender value is an important consideration in reviewing SVP crawl-out methodologies. Such an analysis requires a mathematical review of the crediting rate formula and projections of future values to compare 1) interest credited in the absence of surrender; and 2) interest credited in the event of surrender. **Again, if the two are not the same, then it is difficult to argue the participation in the cash surrender value post-surrender is unchanged.**

With a typical CR formula, it becomes apparent that the relationship between the MV and the BV (the MV/BV ratio) has a direct impact on the crediting rate and, by extension, the growth of the book value. If the ratio is less than 1, it will result in a crediting rate that is less than the yield of the portfolio. (Conversely, if the ratio is greater than 1, it will result in a crediting rate that is more than the yield of the portfolio.) The amount by which the MV/BV ratio impacts the crediting rate depends on its magnitude and the value of the Duration variable.

If the book value crawl-out payments result in a change to the MV/BV ratio, then it can be empirically proven that the policyowner's participation post-surrender is not unchanged.

Most SVP agreements use a variation of the following crediting rate formula:

CR = (1 + Y) x ((MV+EA)/BV)^(1/D) - EF -1

Where:

- Y is the Yield to Worst of the investment portfolio (or benchmark, as applicable)
- MV is the portfolio Market Value
- BV is the portfolio Book Value
- D is the length of time, or "Duration" for which the formula will seek to amortize differences between the MV and BV
- EA is the unamortized Enhancement Amount
- EF is the Enhancement Factor that is used to amortize up-front expenses (e.g., premium tax & DAC)

Comparative Example

For illustrative purposes, assume a book value surrender takes place at a time when the MV/BV ratio is less than 1 (here we use 0.95) and the crawl-out payment pattern is to provide substantially equal payments each year for 10 years (i.e., 1/10th of BV in year 1; 1/9th of the remaining BV in year 2; 1/8th of the remaining BV in year 3; … 1/2 of the remaining BV in year 9; and 100% in year 10).[9]

First, we will compare two methodologies for the payments and determine whether or not they satisfy the accounting rule requiring that the participation in the changes in cash surrender value remain unchanged post-surrender:

A. "Equal Dollar Payments" – The payments result in equal dollar reductions to both the MV and the BV.
B. "Proportionate Payments" – The payments result in proportionate reductions to both the MV and the BV (i.e., the MV/BV ratio is unchanged by the payments).

If an empirical analysis of crediting rates – in the absence of surrender and in the event of surrender – results in different projected rates, it is difficult to argue that the participation in the cash surrender value post-surrender is ***unchanged.***

9 Other assumptions in this example are a static portfolio yield to worst ("Y") of 3.00%; static portfolio duration; and a fixed crediting rate duration ("D") of 4 years.

Crawl-Out vs. No Crawl-Out Crediting Rate Comparison

	Payment Year									
	1	2	3	4	5	6	7	8	9	10
No Surrender	1.69%	2.01%	2.26%	2.44%	2.58%	2.69%	2.77%	2.82%	2.87%	2.90%
A. Proportionate Payments	1.69%	2.01%	2.26%	2.44%	2.58%	2.69%	2.77%	2.82%	2.87%	2.90%
B. Equal Dollar Payments	1.69%	1.90%	2.07%	2.20%	2.30%	2.37%	2.41%	2.40%	2.33%	1.98%
B. - A.	*0.00%*	*-0.11%*	*-0.19%*	*-0.24%*	*-0.28%*	*-0.32%*	*-0.36%*	*-0.42%*	*-0.54%*	*-0.92%*

It is clear that equal dollar reductions to MV and BV result in post-surrender crediting rates that differ from the "No Surrender" baseline. This is because the equal dollar reductions, by themselves, result in a reduction in the MV/BV ratio, which reduces future crediting rates.[10] In the above example, the geometric mean crediting rate for the Proportionate Payments and Equal Dollar Payments were 2.50% and 2.17%, respectively. The IRRs of the payment streams were 2.31% and 2.09%, respectively.

It is important to reiterate that the above example assumed no changes to interest rates or duration. Modeling various additional scenarios confirms that the economic differences in the methodologies become even greater under many scenarios (e.g., in a rising interest rate scenario, or if the MV/BV ratio at surrender is even lower).

Based on these empirical findings, it appears clear that an SVP crawl-out solution that results in equal dollar reductions to MV and BV will not satisfy the *unchanged participatio*n test and, therefore, should be subject to discounting.

Impact of Book Value Write Downs

SVP features generally identify a minimum permitted MV/BV ratio. If the unadjusted MV/BV ratio breaches this threshold, the BV is reduced to the extent necessary to restore the MV/BV ratio to the minimum permitted level.

Of course, if an SVP crawl-out solution utilizes a methodology of equal dollar reductions in MV and BV, then the payments themselves will impact the MV/BV ratio, as established above. Assuming that the ratio at surrender is less than 1, the payments will act to further reduce the ratio.

A policyholder must also be particularly wary of any feature that results in equal dollar reductions and allows BV Write Downs to apply post-surrender. This is because the payments themselves could trigger BV Write Downs. This risk is especially significant if the SVP provider has discretion with respect to the timing and amounts of the crawl-out payments.

10 Additionally, as compared to the Proportionate Payments method, the Equal Dollar Reductions also serve to reduce the MV by a relatively larger amount, which further impacts the ability of the MV to grow over time.

Are Equal Dollar Reductions Analogous to Pre-Surrender Partial Surrenders and Withdrawals?

Despite the clear empirical data to the contrary, some SVP issuers and distributors may attempt to argue that equal dollar reductions in MV and BV post-surrender should not be deemed to violate the *unchanged participation* standard. One might attempt to analogize the post-surrender crawl-out payments to pre-surrender distributions (e.g., partial surrenders and withdrawals). Pre-surrender distributions generally are administered as equal dollar reductions to MV and BV. So, if the contract requires any distributions to take place as equal dollar reductions, why wouldn't that comply with the unchanged participation standard?

First, it is fundamental that the cash flows are inherently different and are generally governed by separate provisions under the contracts. Even if a partial surrender will result in a lower MV/BV ratio, which, by extension, will result in a lower future crediting rate, there is no accounting disconnect, because accounting applies a net realizable value standard. Breaking it down further, the net realizable value of the partial surrender is the amount received (provided it is within one year). The net realizable value of the remaining policies is the amount realizable if they were to be surrendered as of that balance sheet measurement date.

*If one were to allow equal dollar reductions in a post-surrender crawl-out to satisfy the accounting standard, it would imply that the accounting value can hold even though it is impossible for the policyholder to **realize** that value.*

If one were to allow equal dollar reductions in a post-surrender crawl-out to satisfy the accounting standard, it would imply that the accounting value can hold even though it is impossible for the policyholder to *realize* that value. In other words, such a policyholder would be guaranteed to receive less than the book value!

Conclusions of Findings and Recommendations

Due to the complexity of SVP features, careful evaluation is required on a number of fronts – the accounting implications are no exception. Several issuers have re-entered the SVP market for VSA BOLI with new solutions, embracing extended payment or crawl-out methodologies. As discussed above, a foundational accounting question is whether or not these extended payouts will require discounting under GAAP.

The following are some key questions to investigate when evaluating a crawl-out SVP product that asserts that discounting does not apply:

1. Does the contract itself mandate (or authorize the SVP provider to mandate) any changes to the investment portfolio characteristics or the crediting rate formula post-surrender? If so, the SVP will likely be subject to discounting.
2. Do the crawl-out payments reduce MV and BV equally or proportionately? As described above, if the reductions are equal, then the SVP will likely be subject to discounting.
3. Can the policyowner demonstrate that the post-surrender participation (i.e., crediting rates) is equivalent to a no-surrender scenario? If not, the feature will likely be subject to discounting.

Even if an SVP feature is deemed to satisfy the *unchanged participation* standard, it is advisable to empirically test the NPVs and IRRs of the post-surrender payments under a variety of scenarios. A policyholder could face a most unpleasant situation if, under audit, it is determined that discounting is required. Upon discounting, the NPV would likely be the best approximation of the carrying value under GAAP, and if the differential is material the consequent write-down of the BOLI carrying value could prove most disconcerting.

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