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Asset Management

US Life Insurance GAAP Accounting Reforms

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US life insurance GAAP (Generally Accepted Accounting Principles) changes are expected as early as 2021. The reforms focus on long-duration contracts such as life insurance, disability, long-term care and annuities, and include:

- *Updated assumptions for liability measurement*
- *Standardizing the liability discount rate*
- *Greater consistency in measurement of market risk benefits (e.g., to align with hedge derivatives)*
- *Simplified amortization of deferred acquisition costs*
- *Enhanced disclosures*

We do not believe that potential accounting volatility resulting from these new reporting rules will change the underlying economics, cash flow or protection measures for U.S. life insurance investors.

US public companies are required to file GAAP financials with the SEC, including insurance holding companies which report consolidated results for their regulated and unregulated (non-insurance) subsidiaries. Insurers also report to constituents including rating agencies and state regulators. GAAP provides a consolidated view of an otherwise complex business, particularly given assumptions of future costs. It should be noted that accounting data under GAAP, and statutory financial statements (STAT) required by state regulators, differ significantly, as a result of contrasting methods for measuring inputs.

GAAP impact on policyholder liabilities

Life insurers currently value many of their policyholder liabilities (*e.g.,* reserves for future insurance payouts) based on the expected return on general account (GA) investments backing those obligations. With the accounting changes, life insurers could be *penalized* by the requirement to provide a quarterly mark-to-market of liabilities, using a "standardized, market-observable discount rate" based on a high-quality corporate bond rate**. If a GA, with above-market return characteristics, is required to use a lower discount rate, this would inflate GAAP liabilities.**

Historically, assumptions such as life expectancy and lapse rates were determined at contract inception and updated for significant deviations. With the policyholder liability measurement change, any update to these assumptions will be reflected at least annually, with the effect recorded in net income. Going forward there can be more frequent changes to assumptions which could drive earnings volatility.

GAAP changes important?

Rating agencies are expected to take a more measured approach to the reforms. Moody's stated that the changes "*only affect GAAP accounting and not regulatory [STAT] financials or the underlying business economics."* While GAAP accounting remains an important consideration — and enhanced disclosure is certainly welcome — STAT ultimately governs an operating subsidiary's ability to distribute cash to service holding company debt and equity payments. STAT accounting is especially important to credit investors such as Spectrum. **While recognizing the importance of upcoming GAAP financial reporting changes, Spectrum believes sound business economics, conservative rating agency requirements and constructive state regulation underscore strong fundamentals for the names in which we invest.**

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