Unlocking the Net Premium Ratio for Changes to Cash Flow Assumptions

Though a retrospective unlocking approach for changes to cash flow assumptions might ultimately provide some practical benefits, there would be significant challenges:

1. It requires maintenance of history (assumed and actual) and current accounting. However, most current valuation systems do not retain this history in sufficient detail. Thus, companies would face the dual challenge of major system changes and finding a reasonable estimate of pre-transition history.

2. The common practice of valuing traditional insurance liabilities at the individual contract level would become impractical for several reasons, some of which are explained in the footnotes.[6] Systems designed for seriatim valuation would have to be replaced or substantially rewritten. Though systems of valuing universal life-type contracts might be more easily modified to effectively handle traditional contracts, many could not be done so efficiently.

3. The difficulties that financial statement users have with understanding the effects of retrospective unlocking of deferred acquisition costs (DAC) and unearned revenue liabilities on universal life-type contracts might now be seen with traditional contract liabilities.

4. In general, this would enhance consistency between traditional and universal life-type valuations, but traditional contracts would have a zero floor on the liability while similar universal life-type contracts would have an account value floor. For some products, this will be significant.

5. Liabilities for limited payment contracts will be more sensitive to assumption changes as they approach and pass their pay-up date than similarly funded universal life-type products. This difference will be greatest for products with short premium paying periods.

The first two are principally transition issues, and might be lessened with either the prospective or locked-in net premium ratio approaches. If applied consistently to traditional and universal life-type products, system maintenance after transition may be easier than current needs for two different system designs.

credited rates (including rates implicit in the dividend scale) would need to be treated consistently with the discount rate change. But this need not affect other changes to projected cash flows.

[5] We note that the approaches we suggest for OCI are consistent with the optional OCI permitted under the International Accounting Standards Board's (IASB) decisions. A locked-in net premium ratio without OCI would be effectively consistent with the IASB's decisions to the extent that OCI is not elected. In either case, International Financial Reporting Standards (IFRS) reporters will be required to split the discount rate impact from the impact of cash flow assumptions.

[6] To take one simplified example, consider the effect of an unexpected death claim. To apply retrospective unlocking, we would need to recalculate liabilities using a net premium ratio that takes into account the actual extra death. If, however, the valuation is performed at an individual contract level, the contract on which the unexpected claim occurred is no longer in force, and so the retrospective unlocking relating to the experience would not be reflected.