APPLYING THE GAAP NET REALIZABLE VALUE STANDARD TO BOLI STABLE VALUE PRODUCTS

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INTRODUCTION[1]

Businesses commonly provide certain pre- and post-retirement benefits to their employees, such as health care benefits and retirement plan contributions. These benefits can result in substantial liabilities and expenses, which the business must reflect in its financial statements. Since the 1970s, businesses have routinely purchased permanent, cash value life insurance coverage on the lives of their officers, directors, and employees in order to informally finance certain employee benefits. Such coverage, when purchased by financial institutions, is often referred to as Bank-Owned Life Insurance ("BOLI").

There are a few primary structures for BOLI policies; one uses variable insurance products (commonly referred to as Separate Account BOLI). In Separate Account BOLI, the policyowner bears most of the risk associated with the underlying investments that fund the contract. One effect of this risk is that the policyowner's cash surrender value (i.e., the amount it would be entitled to receive upon termination of the insurance contracts) is generally based on the liquidation value of the underlying investments (i.e., the "market value"). Given the near-term market value fluctuations associated with such variable products, SA BOLI products frequently utilize Stable Value Protection ("SVP") features to amortize market value returns over extended periods of time, thereby alleviating material earnings volatility.

In 1985, after observing diversity in practice, the Financial Accounting Standards Board ("FASB") set forth a clear standard for the carrying value of permanent life insurance (FASB Technical Bulletin 85-4, or "FTB 85-4"). FASB concluded, "The amount that *could be realized* under the insurance contract as of the date of the statement of financial position should be reported as an asset" (emphasis added). Of note, FASB considered and rejected various alternative valuation approaches.[2]

Historically, SVP features primarily accomplished the goal of reducing marked-to-market volatility by establishing a stabilized "Crediting Rate Formula" and having a counterparty contractually agree to bridge any difference between

[1] The authors would like to acknowledge the significant feedback and contributions of David Finder and Mat Abernethy (Deloitte Tax LLP)

[2] For example, FASB rejected the view expressed in paragraph 9 of FTB 85-4:

> Some respondents view the dominant objective of a life insurance contract to be investment. Subject to certain criteria evidencing an intent to continue the contract, they maintain that the contract meets the definition of an asset established in paragraph 19 of Concepts Statement 3, which states, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted). Those who hold this view suggested that such contracts should be accounted for using methods that result in reporting the investment in life insurance at amounts different from those stipulated in the contract. (emphasis added)

market value and the stable value ("book value") if and when a policyowner were to elect to terminate the insurance contracts (thus making the book value *realizable* under FTB 85-4).

At present, new SVP offerings present a challenge for the BOLI market to ensure that such offerings are properly accounted for in conjunction with the established GAAP standards. Some new offerings may expose policyholders to significant valuation adjustments (i.e., write-downs) for book accounting purposes – primarily by seeking to comply with GAAP under a provision that may be construed to not require a *realizable value*. In this article, we'll explore this topic further. In the first section we review the applicable GAAP accounting standards. In the second section, we provide examples of SVP contractual designs that result in either *de minimis,* or no, risk being borne by the SVP provider. These arrangements may present accounting, tax, and possibly reputational risk to BOLI policyowners, BOLI underwriting insurers and SVP issuers – especially if they become widely adopted.

SECTION 1 – REVIEW OF APPLICABLE GAAP ACCOUNTING STANDARDS

FASB A.S.C. 325-30 sets forth the relevant GAAP standards for accounting for BOLI. Its content can be traced back to FTB 85-4 (noted above) and clarifications to FTB 85-4 as a result of FASB's Emerging Issues Task Force in EITF 2006-5.

EITF 2006-5: FASB Reaffirms Net Realizable Standard

It is well known in the BOLI industry that FASB's EITF 2006-5 reviewed the accounting treatment for life insurance. It is interesting to note that all of the EITF's deliberations focused on clarifying the "amount that could be realized… in accordance with FTB 85-4." In particular, the EITF considered three primary issues:

1. *Additional Amounts:* Whether additional amounts included in the contractual terms of the insurance policy should be reflected in the "amount that could be realized… in accordance with FTB 85-4";
2. *Surrender All:* Whether a policyholder should consider the contractual ability to surrender all policies at the same time in determining "the amount that could be realized… in accordance with FTB 85-4"; and
3. *Discounting if Surrender Limitations Exist:* **"Whether the cash surrender value component of the amount that could be realized in accordance with FTB 85-4 should be discounted in accordance with APB 21, when contractual limitations on the ability to surrender a policy exist**."

To set the stage for our analysis, it is worth highlighting the conclusions that FASB reached on each of these deliberations.

1. *Additional Amounts*: Policyholders should consider any additional amounts (e.g., DAC refunds and mortality reserves) included in the contractual terms of the policy in determining the amounts that could be realized upon a surrender; **amounts that are recoverable only at the carrier's discretion should be excluded**; and **amounts recoverable in periods beyond one year from the surrender should be discounted in accordance with APB Opinion 21**.[3]
2. *Surrender All*: FASB largely rejected a determination of carrying value based on a policyholder's decision to surrender all policies at once; however, FASB noted that the amount that would be ultimately realized on the surrender of the last policy should be included in the amount that could be realized under the insurance contract.
3. *Discounting if Surrender Limitations Exist*: Below is the excerpt from the minutes of FASB's Board Meeting on 9/20/2006 where the EITF consensus was formally ratified (emphasis added).

> **"**The Task Force reached a consensus that **a policyholder should not discount the cash surrender value component** of the amount that could be realized **when contractual restrictions on the ability to surrender a policy exist.** However, the Task Force observed that **if the contractual limitations prescribe**

[3] APB Opinion 21 was subsequently incorporated into ASC 835-30.

> **that the cash surrender value component would not continue to function as originally intended during the period of restriction, then a fixed amount that can only be realized under the insurance contract at a future date should be discounted** in accordance with Opinion 21." [4]

Importantly, we observe no indication of FASB expressing a view that it would be appropriate to account for BOLI at a value that is **not "an amount that could be realized."**

To better understand FASB's intent, particularly with regard to its conclusion on discounting, we carefully reviewed the 2006 EITF discussions and the FASB Board Meeting minutes ratifying the EITF consensuses. We describe our findings below; however, we find it unlikely that FASB meant: *As long as your hypothetical contract value changes [i.e., is not a fixed amount] after you have elected to surrender the policy, then you need not consider the value that is ultimately realizable upon a surrender when determining your carrying value.*

What are "contractual restrictions on the ability to surrender" and what was FASB's intent?

The excerpt we included above from the 9/20/2006 FASB Board Meeting minutes with regard to the applicability of discounting when surrender limitations exist and the corresponding Codification entry in FASB ASC 325-30-35-6 raise a series of questions:

- What is a "contractual restriction on the ability to surrender"?
- What does it mean to "function as originally intended during the period of restriction"?
    - Note: In ASC 325-30-35-6, this concept is written as: "…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."
- Why does FASB appear to refer only to a "fixed amount" realized at a future date as being subject to discounting?
    - Note: In ASC 325-30-35-6, this concept is written as (emphasis added): "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…at a future date shall be discounted…"

We explore each of these questions in detail below.

Contractual Restrictions on the Ability to Surrender

FASB's 2006 discussion of the issues under EITF 2006-5 includes the following excerpts:

- EITF Agenda Committee Report dated 2/2/2006, page 11 includes:

  > "…the guaranteed amount associated with the surrender of the group life policy is contingent on certain criteria being met. **This [sic] criteria can include change in control provisions, the insured entity (financial institutions) being a "well capitalized" institution under the regulatory capital rules, and other items that the staff understands to be typical business purpose provisions within the control of the entity."** (emphasis added)

- Issue Summary 1 dated 5/24/2006, Paragraph 13 states:

  > "…many of the provisions limit the amount that is realized… and may necessitate meeting certain criteria in order to recover any of these amounts. These limitations should be considered when determining the amounts that could be realized in accordance with the insurance contract**. Some of the more typical examples of limitations that exist are the prohibition against having a change of control or restructuring occurring within the last 24 months; a planned restructuring within the next 12 months; or the extent to which the policyholder is in a net NOL carryforward position**. … The amount associated with the termination of the policy may be received over an extended period of time subsequent to the surrender of the insurance policy or certificate. **The expected payment pattern should be considered in measuring the amount that will be realized**." (emphasis added)

[4] Minutes of September 20, 2006 Board Meeting: Ratification of EITF Consensuses and Tentative Conclusions, dated September 26, 2006 (see paragraph 9).

- Issue Summary 1, Supplement No. 1 dated 8/15/2006, paragraph 7 states:

  "There is, however, one issue that the staff believes the Task Force needs to address as a result of the comment letters received concerning the measurement of the cash surrender value when contractual restrictions restrict the ability of the policyholder to actually surrender the policy.

  Whether the cash surrender value component of the amount that could be realized in accordance with FTB 85-4 should be discounted in accordance with APB 21, when contractual limitations on the ability to surrender a policy exist.

  This issue relates only to the cash surrender value component of the amount that could be realized for the policy and all other amounts would be discounted based on the Task Force's previous consensuses. …

  The following scenarios will be used to illustrate the application of the views under this Issue:

  - Scenario 1 – The policyholder (employer) has an insurance policy on an employee. The employer enters into a separate agreement whereby the employer agrees not to surrender the insurance policy. The life expectancy of the employee is 12 years. The cash surrender value (CSV) of the policy is $1,000,000.

  - **Scenario 2 – The insurance policy requires that for the preceding two-year period and for the succeeding two year period, the policyholder cannot surrender the insurance policy if there has been a change in control.** On December 31, 2006, there was an event that was considered a change of control in accordance with the insurance policy. The CSV of the policy is $50,000" (emphasis added).

It appears that most of the contractual limitations on the "ability to surrender" a policy considered by the Task Force were actually contractual requirements to qualify for a book value settlement[5] under typical SVP features. The provisions described typically do not prevent a policyholder from being able to surrender; they simply impact the value that the policyholder may be entitled to receive upon a surrender.

As the excerpts above indicate, in considering the additional question posed by the Task Force for comments in its 8/15/2006 Supplement, FASB set forth two scenarios as examples. Each of them describes a "temporary" restriction, whereby the referenced contractual amount will eventually become fully realizable. Scenario 2 was particularly germane to BOLI Stable Value Protection because it references a common SVP provision that must be satisfied in order to qualify for "book value" on a surrender.[6]

What is meant by "Function as Originally Intended During the Period of Restriction"?

FASB reached a consensus conclusion that a policyholder need not discount the cash surrender value component when contractual restrictions on the ability to surrender a policy exist. However, the Task Force observed that if the contractual limitations prescribe that the cash surrender value component would not continue to function as originally intended during the period of restriction, then the amount that can be realized at a future date should be discounted.

It is worth noting that SVP features with provisions similar to the examples provided by FASB (e.g., change of control, NOLs, well-capitalized, etc.) typically continue to participate in a fully unchanged basis during such a period of "temporary" restriction. For example, there is no mandated investment reallocation/immunization event or adjustment to the crediting rate process that applies during the 2-year period following a change of control. As such, it is quite logical to exempt such amounts from discounting during the temporary period of restriction because: 1) after the temporary restriction period expires, the policyholder can once again surrender the contract for the full book value; and

[5] "Book value" as used in this context generally refers to the account value associated with the BOLI contract that is associated with the SVP; it is reflective of interest credits that have been accrued based on the contractual terms of the SVP feature.

[6] A policyowner is often required to represent that it has not been subject to a "change in control" during the prior two-year period in order to qualify for a book value settlement under the SVP agreement.

2) during the period when it couldn't surrender for the book value, the policyholder fully participates in the policy growth/performance without any changes.

Therefore, the conclusion reached by the EITF has given policyholders a sound basis for continuing to carry policies at book value if there is a "temporary" inability to meet the conditions to be able to realize the full contract values.

FASB understandably concluded that if the policyholder's participation in policy growth changes, then it is outside the scope of this narrow exception to discounting.

Why does FASB Refer to a "Fixed Amount"?

We were unable to determine why FASB used references to a fixed amount (or singular "amount") when suggesting that discounting applies.[7] The question is binary: Does a particular scenario require a future value to be discounted (Yes or No)? FASB provides a fairly clear basis for "No." As described above, it means that the policy will operate "as intended" without change during the temporary restriction and the amount will eventually be fully realizable (i.e., when the temporary restriction no longer applies).

Unfortunately, FASB doesn't provide as much clarity for a "Yes" answer in the context of a "temporary restriction on the ability to surrender." It is likely worth noting that ASC 325-30-35-4 provides an unambiguous requirement that amounts receivable beyond one year must be discounted to reflect a present value.

One might query whether a valid argument can be made that a non-fixed, future value falls outside discounting to present value simply because it is not a *fixed* value? For example, could one avoid discounting by crediting a minimal (potentially variable) return from quarter to quarter or by any other means to prevent a precise forecasting of a fixed future amount?

Substance Over Form Principle

While a detailed understanding of FASB's accounting guidance for life insurance is important, one should not ignore the key accounting principle of "substance over form." Substance over form is a GAAP accounting principle meaning that the *economic* substance of transactions and events must be recorded in the financial statements rather than just their legal form in order to present a true and fair view of the affairs of the entity.

In the next section of this paper, we provide an initial analysis of certain approaches currently being offered to BOLI policyowners. Simplistically, if it can be demonstrated that the SVP provider has virtually no risk of bearing a payment obligation (i.e., no risk of a payout in excess of market value), then the SVP issuer may not be providing economic value to the policyowner. If there is no economic value attributable to the SVP contract, the contract may be vulnerable to accounting scrutiny and subsequent BOLI asset value restatement for the policyowner.

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[7] Excerpts from 9/20/2006 EITF Board Meeting minutes and ASC 325-30-35-6 (emphasis added)

EITF: "...if the contractual limitations prescribe that the cash surrender value component would not continue to function as originally intended during the period of restriction, **then a fixed amount** that can only be realized under the insurance contract at a future date should be discounted..."

ASC: "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…at a future date shall be discounted…"

SECTION 2 – EXAMPLE CONTRACT DESIGNS WITH QUESTIONABLE ECONOMIC SUBSTANCE

Three basic approaches can be taken to provide a stable, realizable value in BOLI:

1. The contract value can be paid out within one year of surrender;
2. The contract value can be paid in periods that extend beyond one year from surrender (where the value ultimately payable must be discounted to reflect a present value); or
3. The contract value can be paid in periods that extend beyond one year from surrender but seek to employ an exception from the requirement to discount the future flows.

The first approach is straightforward, and the second approach incorporates discounting. Accordingly, we analyze the underpinnings of the third approach (i.e., extended payouts that seek to avoid a present value standard) in greater detail. Below, we discuss a few BOLI SVP product design features that may be intended to qualify an SVP contract for the exception to discounting.

Extended Crawl-Out with Investment Discretion to Force Money Market/Treasuries

SVP contract provisions that either require the pre-surrender portfolio to be effectively de-risked (e.g., forcing a reallocation to money markets or short duration Treasuries) or provide the SVP provider the right to require such changes clearly alter the policyholder's participation in the underlying life insurance contract. We believe, more likely than not, that SVP solutions containing any similar provisions may be required to be discounted to reflect a present value.

This conclusion is consistent with feedback we have received directly from accountants and auditors for years. However, let's suppose for a moment that one takes a more liberal interpretation of what it means to "participate in the changes in the cash surrender value as it had done before the surrender request."[8] In particular, query whether the fact that the cash surrender value would continue to change subsequent to a surrender election by continuing a crediting rate process or by some other means is sufficient to escape the need to discount the future amounts that may be receivable. If so, then we ask: What is the "net realizable value" of such an arrangement?

Let's assume an arrangement is in force with the following parameters: Market Value of underlying investments (MV) = $90 million; Book Value (BV) = $100 million; a lump sum contractual BV surrender payment that is set for 7.5 years after a surrender election; the typical crediting rate formula applies during the post-surrender period; and the SVP issuer has investment discretion.

From the SVP issuer's perspective, the post-surrender investment discretion is a highly material provision, since it minimizes or eliminates any risk of loss arising from a book value payment obligation. Let's explore why this is the case.

By mandating money market and/or short duration treasury investments, the typical crediting rate formula will use the yield (Y) of the de-risked investment portfolio and a Duration variable of ~0.25. If Y equals 2% in our example, the initial post-surrender crediting rate will be set to the contractual floor of 0%. This means that the book value will decrease during the first reset period (because of the insurance fees, including the SVP fees).[9] The growth/positive earnings from the money market/treasury portfolio will increase the MV, net of the insurance fees. As such, the gap between the book value and the market value will decrease.

Fast forward to the next crediting rate reset… what will the new BV crediting rate be? It will be 0%. The book value will again decrease during the next period while the money market (or short duration treasury investments) generate low, fairly predictable, positive yields for the market value. As such, the gap between the book value and the market value will decrease again.

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[8] See FASB ASC 325-30-35-6

[9] Our example assumes total policy costs equal 45 bps.

Below is a schedule that assumes that the short-term yields are 2% throughout the post-surrender period (Table 1).

Table 1

Quarter	Beginning MV	Beginning BV	Crediting Rate
1	90,000,000	100,000,000	0.00%
2	90,346,741	99,887,310	0.00%
3	90,694,818	99,774,746	0.00%
4	91,044,236	99,662,310	0.00%
5	91,395,000	99,550,000	0.00%
6	91,747,116	99,437,817	0.00%
7	92,100,588	99,325,760	0.00%
8	92,455,422	99,213,829	0.00%
9	92,811,623	99,102,025	0.00%
10	93,169,196	98,990,347	0.00%
11	93,528,147	98,878,794	0.00%
12	93,888,481	98,767,367	0.00%
13	94,250,203	98,656,066	0.00%
14	94,613,318	98,544,890	0.00%
15	94,977,833	98,433,839	0.00%
16	95,343,752	98,322,914	0.00%
17	95,711,081	98,212,114	0.00%
18	96,079,825	98,101,438	0.00%
19	96,449,989	97,990,887	0.00%
20	96,821,580	97,880,461	0.00%
21	97,194,603	97,770,159	0.00%
22	97,569,062	97,659,982	1.62%
23	97,944,964	97,944,559	2.00%
24	98,322,315	98,322,316	2.00%
25	98,701,119	98,701,119	2.00%
26	99,081,383	99,081,383	2.00%
27	99,463,111	99,463,111	2.00%
28	99,846,311	99,846,311	2.00%
29	100,230,986	100,230,986	2.00%
30	100,617,144	100,617,144	2.00%
Ending Values	**101,004,789**	**101,004,789**	

In the example above, the crediting rate was floored at zero for 5.5 years. This resulted in a total decrease in the "book value" from the surrender date to the date that the crediting rate rose above 0% of ~$2.3 million. At the payment date, it is worth noting that the market value and book value are identical. As an interesting side note, the SVP provider would likely have collected an additional 7.5 years of SVP fees.[10] Is it reasonable to assert that the policyholder in this situation *realized* $100 million? When we discount the amount received by the riskless rate, we arrive at a realizable value closer to $87 million.

It is worth noting that certain SVP solutions currently being marketed may have post-surrender periods that are much longer than the post-surrender period illustrated above.

[10] Assuming an SVP fee rate of 15 bps, the SVP fees during the extended payment period would have been ~$1.1 million.

SVP Design Question – What if the SVP Contract Explicitly Authorizes the SVP Issuer to Dictate the Investment Positioning at Any Time?

The premise and example described above appear to be readily apparent. It may be difficult to successfully convince an accountant or auditor that such a design results in a "net realizable value" of the book value at the time of surrender. The second key question is: Does it need to be a "net realizable value"?

Let's suppose that the SVP contract, from day one, authorizes the SVP issuer to exercise discretion over the underlying investments at any time. One may attempt to argue that there was "no change" after the book value surrender request, since the SVP issuer could have locked the policyholder up in money market before (or even in the absence of a surrender). Therefore, isn't the policyholder participating on an ***unchanged basis***? If so, doesn't FASB ASC 325-30-35-6 provide an exception from needing to discount the cash surrender value during the "temporary restriction"?

Does an exception from discounting really mean that the policyholder can carry the asset at a demonstrably unrealizable value? Such a result strikes us as inconsistent with FASB's apparent intent in crafting stable value guidance.[11] Consistent with our review of the underlying GAAP in Section 1, we suspect that the investment in the life insurance must still be carried at a "net realizable value."

Extended Crawl-Out with Periodic Payments; Equal Dollar Reductions and Write Downs

In a prior whitepaper (*Caveat Emptor*)[12], we provided an empirical analysis that demonstrated that a series of post-surrender crawl-out payments administered as equal reductions of both the market value and the book value results in a materially lower net realizable value (attributable solely to the mathematics of the process).

We have economic substance concerns about SVP features that allow BV write downs to continue to apply during a post-surrender crawl out process.[13] We have observed SVP proposals that offer to institute a higher minimum crediting rate during the post-surrender process.[14] What if the minimum post-surrender crediting rate is set at a seemingly reasonable level, say 5%? Would that not result in a reasonable interest rate participation for the policyholder during the crawl out period? Let's examine it.

We'll return to the same basic assumptions: $90 million MV; $100 million BV; 7.5 years (30 quarter) crawl-out. Instead of mandating money market/short duration; this variation mandates an "Immunization" portfolio where the holdings are all Treasury holdings with final maturity not extending beyond the payment date. Let's assume such a portfolio has a yield of 4%. Finally, let's assume the SVP contract provides a 5% minimum post-surrender crediting rate and the arrangement employs a BV write down if the MV/BV ratio falls below 85%.

The cumulative sum of the 30 book value payments in such a scenario is $104.27 million (without any discounting or time value of money consideration). However, if the policyholder had $100 million to start and a *minimum* crediting rate of 5%, wouldn't one expect the contract value to reach that value (or more) after just the first year?

If we sum the quarterly write downs in this scenario, they total ~$16.4 million. The total SVP issuer payment liability after including the write downs (on a non-discounted basis) is approximately 0.36 bps. To be clear, the "liability" went

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[11] Notwithstanding the apparent substance issue whereby the SVP issuer has no incentive to exercise its pre-surrender investment discretion since the post-surrender discretion is enough to virtually guarantee no risk of loss.

[12] See Caveat Emptor: New BOLI SVP Features May Present Undesirable Accounting Implications dated January 29, 2019; Available: https://www.mbschoen.com/resources/library/caveat-emptor-svp/

[13] Note that if the SVP feature discontinues book value write-downs during the extended crawl-out period, it would be difficult to argue that participation in the contract has not changed.

[14] As we showed in our example of a money market post-surrender allocation process, a zero percent crediting rate results in erosion of book value (due to the insurance fees). Interestingly, one would seemingly be likely to conclude that modifying the minimum crediting rate would be a change in the participation in the contract as well.

from $10 million notional value at the surrender election, to $3,600. In addition, under the scenarios we've described here, the SVP provider is likely authorized to collect fees throughout the post-surrender payment process.

Below is a schedule of the quarterly distributions and write downs from this example (Table 2).[15]

Table 2

Quarter	Beginning MV	Beginning BV	Distribution	Crediting Rate	MV/BV	Write Down
1	90,000,000	100,000,000	3,333,333	5.00%	90.0%	-
2	87,566,667	97,916,667	3,376,437	5.00%	89.4%	-
3	85,065,897	95,764,188	3,420,150	5.00%	88.8%	-
4	82,496,406	93,541,091	3,464,485	5.00%	88.2%	-
5	79,856,885	91,245,870	3,509,457	5.00%	87.5%	-
6	77,145,997	88,876,987	3,555,079	5.00%	86.8%	-
7	74,362,378	86,432,869	3,601,370	5.00%	86.0%	-
8	71,504,632	83,911,911	3,648,344	5.00%	85.2%	-
9	68,571,335	80,672,158	3,666,916	5.00%	85.0%	640,307
10	65,590,132	77,164,861	3,674,517	5.00%	85.0%	848,783
11	62,571,516	73,613,548	3,680,677	5.00%	85.0%	841,356
12	59,516,554	70,019,475	3,685,236	5.00%	85.0%	833,565
13	56,426,484	66,384,098	3,688,005	5.00%	85.0%	825,384
14	53,302,743	62,709,109	3,688,771	5.00%	85.0%	816,785
15	50,146,999	58,996,470	3,687,279	5.00%	85.0%	807,732
16	46,961,190	55,248,459	3,683,231	5.00%	85.0%	798,188
17	43,747,571	51,467,731	3,676,266	5.00%	85.0%	788,103
18	40,508,780	47,657,389	3,665,953	5.00%	85.0%	777,422
19	37,247,915	43,821,077	3,651,756	5.00%	85.0%	766,076
20	33,968,638	39,963,104	3,633,009	5.00%	85.0%	753,980
21	30,675,315	36,088,606	3,608,861	5.00%	85.0%	741,027
22	27,373,208	32,203,774	3,578,197	5.00%	85.0%	727,079
23	24,068,743	28,316,168	3,539,521	5.00%	85.0%	711,956
24	20,769,909	24,435,187	3,490,741	5.00%	85.0%	695,412
25	17,486,867	20,572,785	3,428,797	5.00%	85.0%	677,101
26	14,232,938	16,744,633	3,348,927	5.00%	85.0%	656,514
27	11,026,341	12,972,166	3,243,041	5.00%	85.0%	632,849
28	7,893,563	9,286,545	3,095,515	5.00%	85.0%	604,732
29	4,876,984	5,737,628	2,868,814	5.00%	85.0%	569,484
30	2,056,940	2,419,929	2,056,940	5.00%	85.0%	520,605
	20,569	24,199	24,199	5.00%		369,039
Totals			**104,273,825**			**16,403,481**

[15] Note that this example does not assume any policy costs; the addition of costs would further reduce the realized values.

What if we increase the minimum crediting rate even more? Perhaps 10%? Interestingly, the cumulative SVP payments equal ~$104.2 million (virtually unchanged from the 5% minimum crediting rate scenario), but the post-surrender write downs rise to ~$37 million (see Table 3).

Table 3

Quarter	Beginning MV	Beginning BV	Distribution	Crediting Rate	MV/BV	Write Down
1	90,000,000	100,000,000	3,333,333	10.00%	90.0%	-
2	87,566,667	99,166,667	3,419,540	10.00%	88.3%	-
3	85,022,793	98,226,293	3,508,082	10.00%	86.6%	-
4	82,364,939	96,899,928	3,588,886	10.00%	85.0%	273,940
5	79,599,702	93,646,709	3,601,796	10.00%	85.0%	2,086,832
6	76,793,903	90,345,768	3,613,831	10.00%	85.0%	2,040,312
7	73,948,011	86,997,660	3,624,903	10.00%	85.0%	1,992,921
8	71,062,589	83,603,046	3,634,915	10.00%	85.0%	1,944,654
9	68,138,300	80,162,705	3,643,759	10.00%	85.0%	1,895,501
10	65,175,923	76,677,557	3,651,312	10.00%	85.0%	1,845,457
11	62,176,370	73,148,671	3,657,434	10.00%	85.0%	1,794,513
12	59,140,700	69,577,295	3,661,963	10.00%	85.0%	1,742,660
13	56,070,145	65,964,876	3,664,715	10.00%	85.0%	1,689,888
14	52,966,131	62,313,095	3,665,476	10.00%	85.0%	1,636,188
15	49,830,316	58,623,901	3,663,994	10.00%	85.0%	1,581,545
16	46,664,625	54,899,559	3,659,971	10.00%	85.0%	1,525,946
17	43,471,301	51,142,707	3,653,050	10.00%	85.0%	1,469,371
18	40,252,963	47,356,427	3,642,802	10.00%	85.0%	1,411,797
19	37,012,691	43,544,342	3,628,695	10.00%	85.0%	1,353,194
20	33,754,123	39,710,732	3,610,067	10.00%	85.0%	1,293,523
21	30,481,597	35,860,703	3,586,070	10.00%	85.0%	1,232,732
22	27,200,343	32,000,403	3,555,600	10.00%	85.0%	1,170,746
23	23,916,746	28,137,348	3,517,169	10.00%	85.0%	1,107,465
24	20,638,745	24,280,876	3,468,697	10.00%	85.0%	1,042,737
25	17,376,436	20,442,866	3,407,144	10.00%	85.0%	976,336
26	14,143,056	16,638,889	3,327,778	10.00%	85.0%	907,904
27	10,956,709	12,890,245	3,222,561	10.00%	85.0%	836,838
28	7,843,714	9,227,899	3,075,966	10.00%	85.0%	762,041
29	4,846,185	5,701,394	2,850,697	10.00%	85.0%	681,236
30	2,043,950	2,404,647	2,043,950	10.00%	85.0%	588,585
	20,439	24,046	24,046	10.00%		396,767
Totals			**104,208,204**			**37,281,627**

Finally, what if the MV/BV write down ratio is reduced – say to 75% (see Table 4)?

Table 4

Quarter	Beginning MV	Beginning BV	Distribution	Crediting Rate	MV/BV	Write Down
1	90,000,000	100,000,000	3,333,333	5.00%	90.0%	-
2	87,566,667	97,916,667	3,376,437	5.00%	89.4%	-
3	85,065,897	95,764,188	3,420,150	5.00%	88.8%	-
4	82,496,406	93,541,091	3,464,485	5.00%	88.2%	-
5	79,856,885	91,245,870	3,509,457	5.00%	87.5%	-
6	77,145,997	88,876,987	3,555,079	5.00%	86.8%	-
7	74,362,378	86,432,869	3,601,370	5.00%	86.0%	-
8	71,504,632	83,911,911	3,648,344	5.00%	85.2%	-
9	68,571,335	81,312,466	3,696,021	5.00%	84.3%	-
10	65,561,027	78,632,850	3,744,421	5.00%	83.4%	-
11	62,472,216	75,871,340	3,793,567	5.00%	82.3%	-
12	59,303,371	73,026,164	3,843,482	5.00%	81.2%	-
13	56,052,922	70,095,509	3,894,195	5.00%	80.0%	-
14	52,719,256	67,077,508	3,945,736	5.00%	78.6%	-
15	49,300,713	63,970,241	3,998,140	5.00%	77.1%	-
16	45,795,580	60,771,729	4,051,449	5.00%	75.4%	-
17	42,202,087	56,269,450	4,019,246	5.00%	75.0%	1,210,477
18	38,604,862	51,473,149	3,959,473	5.00%	75.0%	1,480,422
19	35,031,438	46,708,583	3,892,382	5.00%	75.0%	1,448,507
20	31,489,370	41,985,827	3,816,893	5.00%	75.0%	1,414,232
21	27,987,370	37,316,494	3,731,649	5.00%	75.0%	1,377,262
22	24,535,595	32,714,126	3,634,903	5.00%	75.0%	1,337,174
23	21,146,048	28,194,730	3,524,341	5.00%	75.0%	1,293,420
24	17,833,167	23,777,556	3,396,794	5.00%	75.0%	1,245,267
25	14,614,705	19,486,273	3,247,712	5.00%	75.0%	1,191,708
26	11,513,140	15,350,853	3,070,171	5.00%	75.0%	1,131,286
27	8,558,101	11,410,801	2,852,700	5.00%	75.0%	1,061,767
28	5,790,981	7,721,308	2,573,769	5.00%	75.0%	979,427
29	3,275,122	4,366,829	2,183,414	5.00%	75.0%	877,226
30	1,124,458	1,499,278	1,124,458	5.00%	75.0%	738,722
	11,245	14,993	14,993	5.00%		378,568
Totals			**103,918,565**			**17,165,468**

As illustrated in the examples above, this arrangement does not result in a policyholder *realizing* the book value at the time of surrender. What is realized in this process is instead a value quite close to the market value at the time of surrender.[16]

[16] This result is not surprising since the post-surrender investments are Treasuries whereby the appropriate discount rate is the associated riskless rate. Since the SVP issuer is not bearing any risk or providing any value, it stands to reason that the policyholder will realize the MV.

CONCLUSION

The apparent substance of some SVP offerings in the market today may lead one to question how such products fit within FASB's "net realizable value" standard, which has not been amended in recent years. In fact, FASB has not re-examined its framework for investments in life insurance contracts since EITF 2006-5. Yet we find it unlikely that FASB intended to pave a path for BOLI owners to record asset values that are unrealizable.

As described in the second section of this paper, certain SVP contractual designs that are currently being offered allow the SVP issuer to effectively minimize its risk of payouts in excess of market value. We do not think these SVP offerings comply with GAAP under the exception from discounting set forth in FASB ASC 325-30-35-6 because:

1. The book value settlements clearly result in the payments to the policyholder that extend beyond one year; and
2. Empirical examples of these approaches clearly demonstrate that the policyholder does not *realize* a value commensurate with the purported book value under these contracts.

Adoption of approaches that set aside the premise of *net realizable value* as the underlying foundation for the carrying value could result in undesirable financial reporting adjustments – potentially at very inopportune moments (e.g., when market value is considerably less than book value).

Setting aside internal and external scrutiny in the near term, any modification by FASB to ASC 325-30-35-6 would seem quite likely to leave these products in an untenable position. Given the duration of BOLI programs and their SVP features, policyholders should carefully consider whether certain SVP products really can offer the financial and accounting benefits that a BOLI purchaser would expect an SVP to provide.

AUTHOR BIOGRAPHIES

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With 15 years of experience, Tradyn Foley has become a recognized expert and thought leader in the BOLI industry. He has presented at BOLI conferences and participated in panel discussions. He regularly advises clients on various legislative, regulatory, tax and accounting developments. Tradyn has assisted clients, insurers and BOLI asset managers in complying with changing bank regulatory capital rules (e.g., Basel III) and has submitted several comment letters regarding bank regulatory rulemaking processes.

Tradyn Foley primarily manages the day to day operations of MBSA. Under his leadership, MBSA provides unparalleled reviews of clients' BOLI programs and governance processes.

Tradyn is also a partner in Concept Hedging, LLC.

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John Pfleger applies over 25 years' experience in the investment and insurance industries as a Senior Advisor for MBSA. Known for his creative thinking and problem solving, he has extensive experience in structuring and negotiating insurance contracts with insurance companies and stable value protection providers.

John is also a founding partner of Concept Hedging, LLC, which, among other things, owns and licenses intellectual property related to providing stable value protection for BOLI plans.