Investment Accounting Systems: Keeping up with Ever-evolving Insurance Statutory Requirements

SUMMARY

Investment accounting is an ever-changing process, especially for insurance companies and publicly traded insurers. Statutory accounting regulations (STAT) from the National Association of Insurance Commissioners (NAIC) and accounting rules from the Financial Accounting Standards Board (FASB) for generally accepted accounting principles (GAAP) have been rapidly and broadly changing reporting requirements in response to riskier investment types, new investment categorizations, and changes in accounting rules. Flexibility within investment accounting systems is more critical than ever.

Rules are written or modified annually for investment accounting, which puts pressure on insurance companies to quickly implement new procedures and support systems to remain compliant. Enlisting Meradia's expertise in evaluating your current state, defining your target state, vendor selection, conversion, and implementation can help you successfully navigate through this dynamic environment.

DO NOT RELY ON THE STATUS QUO: THINK SYSTEM FLEXIBILITY

We tend to think of investment accounting needs as static; thus, allowing firms to simply rely on the status quo for their systems. If you ask practitioners at insurance companies who are responsible for investment accounting, then you get a very different picture. This is especially true of publicly-traded insurance companies that must comply with statutory accounting regulations (STAT) from the National Association of Insurance Commissioners (NAIC) and accounting rules from the Financial Accounting Standards Board (FASB) for generally accepted accounting principles (GAAP). These two bodies have been active in changing and refining reporting requirements. Insurance companies have a lot at stake because many of the changes impact income recognition or capital requirements. This dynamic area of accounting places strains not only on insurance companies required to comply, but with vendors that provide investment accounting solutions to the industry, which is why companies contemplating changing investment accounting systems must prioritize system flexibility.

WHAT IS THE BAROMETER FOR MEASURING RISK?

Traditionally insurance companies have invested in securities such as bonds, private placements, and some equities. The realities of a low interest rate environment have forced insurance companies to seek returns in alternative investments such as private equity, bank loans, limited partnerships of various flavors, and others. Some contend this has increased the level of risk insurers are taking. Not all agree, but clearly regulators have taken notice and have made significant changes to procedures. Consider, for example, the recent changes to Risk Based Capital (RBC) for securities. Until 2018 investment accountants calculated RBC using six risk categories which aligned with the NAIC's six ratings and valuation categories for securities. For 2018 the NAIC expanding the six categories to 20 categories, rendering pre-existing logic and tags useless, and necessitating expensive system changes.

WHERE DOES THIS SECURITY GO *THIS* TIME?

The NAIC has a requirement that insurance companies list the details of their equity securities holdings on a schedule know colloquially as D2-2 of the statutory financial statements. During 2018 the NAIC adopted rules that ETFs, Unit Investment Trusts, and Equity Mutual Funds should be considered just like common stocks for reporting purposes. (Bond ETFs and bond mutual funds are considered bonds.) The question is, why did it take until 2018 for official guidance on how to obviously classify these securities? In practice some insurance companies were treating these securities as equity investment already; others classified them as other invested assets for regulatory filing purposes. Along with the classification change, new subcategories were created which must be reflected in the summary schedules that are a part of the annual regulatory filings. This requires more changes to the systems and data elements that support the filings process.

HEDGES, DERIVATIVES, AND STRUCTURED SECURITIES, OH MY!

Other changes adopted during 2018 include new rules on macro hedging for variable annuities (which impact schedules and disclosures about derivatives), changes to the documentation of hedge effectiveness (another derivatives impact), and changes to the valuation methods for loan-backed and structured securities known as LBaSS instruments. This is not intended to be a comprehensive list of all the changes affecting investment accounting that were adopted during 2018; nor have the potential effects of "exposure" drafts been addressed here, and there are many. Additionally, the changes to GAAP reporting requirements which affect all public companies are not delineated. Rather these are examples of how the active environment has and continues to affect insurance companies in terms of the accounting of securities.

THE COST OF STATUTORY CHANGES

These examples illustrate how rules are written and/or modified for investment accounting on an annual basis. These changes pressure insurance companies to quickly implement new procedures and modifications to support systems – and they are costs associated with these implementations. Companies that have home-grown investment accounting systems bear the brunt of new development costs. Companies that rely on vendor solutions see these costs indirectly through maintenance fees and directly through testing and validating to ensure changes have been incorporated accurately, and that there are no unintended consequences. Regardless of what type of system supports the accountants and financial analysts, there are potential implications for reported earnings, reserves, and other balance sheets items.

HOW MERADIA CAN HELP

These examples of statutory changes demonstrate that systems must have great flexibility to efficiently respond to the ever-evolving demands on investment accounting. Meradia has proven methodology and skills to:

- Strategically assess your current state and define your target state
- Develop RFP and select vendor that can best meet your objectives
- Perform conversion and implementation

This paper was produced by Meradia's Investment Accounting experts

Meradia
119 North High Street
West Chester, PA 19380
Phone: 610-738-7787

Info@Meradia.com
www.Meradia.com

Meradia