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U.S. GAAP targeted improvements for long-duration insurance contracts: An update

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The Financial Accounting Standards Board (FASB) has released an exposure draft of targeted changes to the accounting for long-duration insurance contracts.

Allowing for the 75-day comment period and time to prepare a final standard, implementation could be as early as 2018. This paper outlines the major changes proposed by FASB and the potential challenges to implementation and impact they may have on reported financial statements.

Summary of expected changes

The proposal by FASB is meant to address concerns of stakeholders in four key areas. The major changes are summarized below:

To address requests for improving the timeliness of reflecting changes in underlying experience in the liability for future benefits, the FASB is proposing significant changes to the reserves for fixed premium/fixed benefit (FAS 60) contracts. While the reserve method will be unchanged (net premium reserve), all assumptions will be unlocked and no provisions for adverse deviation (PADs) will be allowed. The discount rate will be based on the yields of high quality, fixed-income instruments with the impact of changes in discount rates reflected in other comprehensive income (OCI) instead of operating income.

Stakeholders requested that the amortization of deferred acquisition costs (DAC) for all products be simplified. FASB agreed and proposes that DAC be amortized in proportion to insurance or benefits in-force and that no interest be accrued on the outstanding balance. In addition there will be no loss recognition testing.

To respond to stakeholders' requests to simplify and improve the accounting for certain embedded options and guarantees in variable contracts, FASB proposes that GMxBs for separate account products all be measured at fair value with changes in the value reflected in OCI due to own credit risk.

The fourth major area addressed by the FASB proposal is to improve the disclosures related to insurance.

Full retrospective application of the new accounting standard will be required at transition. DAC will be set to the then existing balance.

Liability assumptions

The FASB has decided to require that all assumptions used in calculating liabilities for future policy benefits for traditional long-duration and participating life insurance contracts be updated on a regular basis and that a provision for adverse deviation will no longer be included in the liability calculation.

The FASB proposal will make a distinction between the treatment of cash flow assumptions and the discount rate. Cash flow assumptions are to be updated at least annually, but should be updated earlier if evidence indicates they should be revised. Discount rates are to be updated quarterly. The effect of updates to cash flow assumptions will be reflected directly in earnings. The effect of changes in discount rates will be reflected in OCI. This is accomplished by locking in the discount rate when determining the change in liability that is reflected in earnings.

> Insurers will have to calculate as many as four reserve amounts at each valuation date. If no assumptions are updated, the insurer will need to calculate liabilities at the locked-in and the current discount rates so that the proper amounts can be charged to earnings and OCI. If only the discount rate is updated, a third reserve amount must be calculated to determine the amount to be charged to OCI during the reporting period. If cash flow assumptions are updated, then a reserve amount must also be calculated using a revised net premium ratio (at the locked-in discount rate).

To reflect updated cash flows assumptions a revised net premium ratio will be calculated using actual historical experience and the updated future period cash flow assumption. The revised net premium ratio will be applied to determine the revised liability as of the valuation date. The difference in the liability under the old and new net premium ratios is reflected in current period earnings. The net premium ratio is capped at 100% of the gross premium. The discount rate used in determining the net premium ratios is the discount rate that applied at inception of the contract.

The effect of updating discount rates is recorded directly in OCI. The amount included in accumulated OCI will be the difference in the liability calculated at the current discount rate and the amount calculated using the discount rate at contract inception.

There will be no separate recoverability or loss recognition test. Instead the net premium ratio will be capped at 100%. Unlike the current standard, DAC and unearned revenue are not considered when reflecting the 100% cap.

The proposal to unlock assumptions and discount rates will also affect limited payment contracts for whom a deferred profit liability is required.

Given that under the anticipated proposal DAC will no longer be amortized in relation to premium and that there is no loss recognition test that reflects DAC, the entire gross premium will now be available to fund the benefit reserve. That fact, coupled with PADs no longer being allowed, could lead to lower net actuarial liabilities for certain products.

Reflecting changes in discount rates in OCI will reduce the volatility of income from changes in discount rates as long as the valuation of assets matches the treatment of discount rates (i.e., unrealized gains and losses are recognized in OCI rather than earnings). FASB did not indicate in its proposal whether insurers will be allowed to re-designate their assets at adoption of the targeted improvements so that their accounting treatment would better match the proposal for liabilities.

Discount rates

For traditional long-duration and participating insurance products, FASB proposes to change the basis of the discount rate to one that is independent of the expected earned rate on assets backing the products. FASB proposes to set the discount rate based on a high quality, fixed-income investment yield that reflects the duration characteristics of the reserve for future policy benefits. FASB has not provided any guidance as to how to define “high quality” other than to mention that some banks and rating agencies publish high-quality rate indices and that pension obligations are discounted at a high-quality rate under current U.S. GAAP.

FASB has indicated that the use of market observable rates should be maximized. A challenge with any approach that relies on observable market-based interest rates is that many insurance liabilities have cash flows that are expected to take place well beyond the last observable yield rate. For points on the yield curve where information is not reliable or not observable, FASB has directed preparers to use estimates consistent with the guidance provided for fair value estimates.

A second issue is whether a single discount rate or a yield curve is expected to be used. When you have asset-dependent cash flows and the cash flows react to a single portfolio rate, is it reasonable to use a weighted average portfolio rate for discounting?

Participating contracts

The FASB proposal represents a significant change in the measurement of participating insurance contracts. Current accounting for such contracts requires a benefit reserve using a net premium valuation based on the assumptions underlying the dividend fund, or the guaranteed non-forfeiture basis if there is no underlying dividend fund. Current or anticipated experience including estimated policyholder dividends are not explicitly included in the valuation. Under the FASB proposal the liability will be measured based on current estimates of future cash flows including anticipated policyholder dividends.

A significant issue with the proposal is that the discount rate may not necessarily be consistent with that underlying the projected dividends. As a result, the liability measurement could be understated or overstated relative to what would be needed to fund the benefits and anticipated dividends. In addition, locking in the discount rate and allowing all changes in discount rate to go through OCI, will exacerbate the mismatch in earnings between the discount rate and the projected dividends as interest rates change over time. It is not clear how the proposal will result in financial statements that communicate the level of profit actually being earned on participating business or the true liability needed to fund the expected cash flows.

Disclosures

FASB will propose that certain additional disclosures be provided for the benefit reserves of both traditional and non-traditional insurance products. Disaggregated roll-forwards of the liability balances will be required along with additional information about estimates and judgments including how they have changed and their effect on the measurement of the liability. For account value-based products, balances need to be presented based on ranges of combinations of minimum guaranteed rates and current credited rates. These disclosures are significantly more involved than those currently required.

Deferred acquisition costs

FASB proposes that DAC for all types of contracts be amortized in proportion to in-force amount of insurance or benefits for annuities. Insurers will no longer need to calculate estimated gross profits or margins. This will be replaced by projections of insurance in-force. No interest will accrue on the DAC balance and no recoverability or loss recognition testing will need to be performed. Sales inducements will continue to be capitalized into a sales inducement asset (SIA), but the amortization will likewise be changed to follow the new amortization methodology for DAC.

This will significantly simplify the calculation of DAC and SIA, and put all products on the same amortization basis. It is not clear whether the proposal will result in faster or slower amortization. The lack of interest accrual will quicken the amortization, but for some contracts the use of insurance in-force instead of margins may lead to a slower amortization. Whether the net impact is slower or faster will likely vary by product and companies' expectations as to termination rates.

At transition to the new proposal, the then existing DAC or SIA balance will be carried over and amortized going forward on the new basis. Any "shadow" DAC or SIA balance in other comprehensive income will be derecognized at the transition.

A separate roll-forward of the DAC and sales inducement balances from the beginning balance to the ending balance for the period will need to be disclosed along with inputs and assumptions used to determine the amortization.

GMxBS for separate account products

FASB proposes that certain types of benefits from "separate account" products that expose insurers to capital market risk be measured at fair value. Current U.S. GAAP accounting requires that benefits such as guaranteed minimum death benefits or income benefits be valued according to SOP 03-1, as the benefits would meet the definition of insurance. The FASB proposal would require them to be measured at fair value consistent with other similar benefits that do not meet the definition for insurance such as guaranteed minimum accumulation or withdrawal benefits (GMABs, GMWBs). The proposed accounting will put all guaranteed minimum benefits (GMxBs) arising from separate account products on the same accounting basis and be more consistent with the valuation of assets that are typically used to hedge the capital market risk of such benefits. If a contract has multiple GMxBs, they are to be bundled together and valued as a single compound benefit.

FASB uses the term "market risk benefits" to describe the GMxBs on separate account products. These benefits must meet two criteria to be deemed market risk benefits.

1. The contract must allow the contract holder to direct funds to one or more separate account investment alternatives and the investment performance, net of fees, is passed through to the contract holder.
2. The insurance entity provides a benefit protecting the contract holder from adverse capital market performance that exposes the insurer to other than nominal capital market risk.

The FASB proposal requires that the change in fair value that is attributable to changes in the entity's own credit risk be reflected directly in OCI. In addition, the carrying value of the market risk benefits is to be shown as a separate line item on the balance sheet and the change in the carrying amount (excluding the change due to own credit risk) is to be shown as a separate line item on the income statement.

Roll-forwards of the liability balances will be required to be disclosed along with the related net amount at risk and fees collected for the benefits. As with the traditional insurance contracts, information regarding significant estimates and judgments and their impact will need to be disclosed. Also to be disclosed will be roll-forwards of the separate account liabilities and the associated cash surrender values.

> The proposal will create an inconsistency with the treatment of similar riders on non-separate account products such as equity indexed (EI) products. The definition of "market risk" includes exposure to interest rates and equity markets, both of which are contained in the EI products, but due to the non-SA nature, are excluded. The board has recognized this inconsistency but decided to limit the scope to variable contracts as stakeholders feedback focused on separate account products.

Transition

FASB proposes full retrospective application of the new guidance. If the reporting entity cannot obtain the needed historical information for all prior periods, it should estimate the information for periods that are not available. The entity should recognize in accumulated OCI the cumulative effect of changes in discount rates between the contract inception date and the transition date.

If it is impracticable for the reporting entity to apply the proposals retrospectively, then they should apply the provisions to the in-force business as of the transition date and update for future assumptions.

In all cases, the opening retained earnings balance needs to be adjusted to the extent the net premium ratio exceeds 100 percent. In the case of full retrospective application, the changes in discount rates would not affect the cap as that impact would be in OCI. However, for the situation where it is impractical to retrospectively apply the proposals, past changes in discount rates would not be in OCI and thus affect the application of the 100% cap.

For market risk benefits, the cumulative effect of changes in the entity's own credit risk between the contract inception date and the transition date should be recognized in accumulated OCI. The difference between the fair value (excluding the cumulative change in own credit risk) and the carrying value at transition would be an adjustment to retained earnings.

The DAC balance at transition would be set equal to the carrying amount prior to transition. Any shadow DAC amounts carried prior to transition would be removed from accumulated OCI.

Timeline

FASB issued the exposure draft in September and has asked for comments to be submitted by December 15, 2016. The FASB should be able to consider the comments and finalize the changes to accounting in 2017. Allowing a year for implementation would mean the changes could be applicable as early as the end of 2018.

FIGURE 1: EARLIEST TIMELINE

Conclusion

While FASB has described its impending proposal as targeted changes, the proposal will have a significant impact on the measurement of liabilities and DAC and earnings emergence for a large portion of the life insurance and annuity products issued by insurers. With mandatory adoption possible as early as year-end 2018, insurers have little time to determine how they will address the impending changes, understand their impact, and communicate revised earnings expectations to their stakeholders. The impact of many of the changes will depend on the specific circumstances of individual companies. In depth analysis will need to be undertaken to determine the best path forward, both for implementing the changes and for commenting on the FASB's exposure draft.

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