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Hitting the Target: Improvements to U.S. GAAP for Long-Duration Insurance Contracts

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In 2014, the Financial Accounting Standards Board (FASB) withdrew from an international project to develop new, comprehensive standards on accounting for insurance contracts. Instead, the board decided to focus on targeted improvements to existing GAAP.

Now nearing the end of deliberations, FASB staff will soon begin drafting amendments. Barring any delays, drafting should begin by the time you read this and we may see an exposure draft in early 2016.

In this article, I first summarize the tentative decisions made on long-duration contracts. I then present a list of risks and opportunities that I see as the decisions become standards. I'll end with a look at practical implications of the project.

TENTATIVE BOARD DECISIONS

February 2014 – The changes will apply only to insurance entities. The project should focus on making targeted improvements to existing U.S. GAAP. The IASB 2013 exposure draft should be considered when contemplating improvements.

April 2014 – The project should address several issues relating to valuation of the liability for future policy benefits, amortization of the deferred acquisition cost asset, premium deficiency and loss recognition, and revenue recognition disclosures.

August 2014 – Assumptions used in calculating future policy benefits for traditional contracts, limited-pay contracts and participating contracts are to be updated annually during the fourth quarter. Effects of the changes are to be included in net income. Provision for adverse deviation should not be included. A premium deficiency test will not be required. Certain disclosures about the liability and assumptions will be required. The guidance for periodic assumption updates will apply also to additional reserves of universal life-type contracts. [The board has yet to address some details of what this means to participating and universal life-type contract liabilities.]

November 2014 – Contracts that are discounted using an expected investment yield under existing GAAP should be discounted using a rate based on a portfolio of high-quality fixed-income investments.

February 2015 – Deferred acquisition costs relating to certain investment contracts will continue to amortize using an effective interest method. Otherwise, deferred acquisition costs will be amortized over the expected life of a book of contracts in proportion to the amount of insurance in force. If the amount in force is not readily determinable, amortization would be straight-line in proportion to the number of contracts outstanding.

July 2015 – Updating of cash flow assumptions will require a retrospective approach. The revised net premium ratio is calculated as of contract inception using actual historical experience and updated future cash flow assumptions. A cumulative catch up adjustment is to be recorded in current-period earnings. The net premium ratio is capped at 100 percent. Updating of the discount rate will require an immediate approach, with no update of the net premium ratio. The difference between the carrying amount of the liability and the amount measured using discount rates locked in at inception will be included in accumulated other comprehensive income.

September 2015 – Variable contract "benefits with other-than-minimal capital market risk" will be measured at fair value. Further research is needed to determine whether the effect of changes in own credit spread should be reported in other comprehensive income.

See *www.fasb.org* for additional details about these decisions and for further updates.

WATCH LIST – RISK AND OPPORTUNITY

Simplification and greater consistency are among the goals of this project. Toward those ends, FASB staff members have openly sought feedback from the industry and our profession and have carefully considered our comments. That has helped to shape some decisions.

Yet, turning decisions into standards cannot guarantee realization of the goals. When interpreting the standards, we risk complicating matters by settling too quickly on what might seem obvious.

To help prevent complication, here is my list of things to watch for in the exposure draft and my current thoughts on how best to address them. Ideally, these will be addressed directly in the final standard and our responses to an exposure draft may help to make that happen. Where ambiguities remain in the final standard, we should take care to interpret them consistent with the project's objectives.

The opinions expressed here are mine and are subject to change as more decisions are made and better ideas emerge.

Asset Yields Lower than Reserve Discount Rate

Situations with expected asset yields below the discount rate might seem to require loss recognition.

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Such deficiencies, however, arise from investment activity and from financial guarantees embedded in the contracts, not from insurance features. GAAP does not permit loss recognition reserves for deficiencies in investment contracts, such as deferred annuities (ASC 944-60-35-6). With respect to interest deficiencies, accounting for insurance contracts should be the same.

Loss Recognition for Universal Life and Participating Contracts

Ensuring reserve adequacy on universal life contracts might require additional reserve calculations for all such contracts, including maintenance expenses, and with a 100 percent cap on the benefit ratio.

Ensuring reserve adequacy on participating contracts might require current best estimate assumptions, including maintenance expenses and policyholder dividends.

DAC Recoverability

Though FASB intends to eliminate the premium deficiency test, the changes do not ensure that contract margins will be sufficient to recover the deferred acquisition cost asset. It seems likely, therefore, that the final standard will require ongoing testing for DAC recoverability.

Such testing should be consistent with the liability valuation. Consistency can be built into reserve valuation systems. By calculating an alternate reserve using identical methods and assumptions, but with a 100 percent net premium or benefit ratio and without a reserve floor, the difference between the calculated reserve and the alternate reserve would represent the amount of DAC the cohort's revenue can support. Summing such amounts from multiple cohorts would allow testing of recoverability at an appropriate level of aggregation.

On traditional contracts, we may need a similar calculation for the current discount rate—a shadow DAC recoverability test—but no new projection should be needed.

On universal life contracts, the benefit ratio will adjust for any change in expected interest margin and its effect on DAC recoverability will be automatic.

Unrealized gains will require a shadow reserve adjustment, equal to the product of the benefit ratio and the amount of unrealized gain or loss. Shadow DAC recoverability will adjust for the remainder of unrealized gains.

Discount Rate for Variable Product SOP Reserve

If any variable product SOP reserves survive the September 2015 decision, the practice of blending general and separate account rates to discount cash flows should end.

Though these are separate account products, the guarantees are backed by general account assets and the reserve discount rate should be determined accordingly.

Profits Followed by Losses

Even after the planned changes, at least two circumstances can result in profits followed by losses—reserve floor and negative revenue. Neither should be considered premium deficiency.

- When current assumptions result in a projection that the reserve will fall below a zero floor, negative earnings might be expected for some time after.

  Negative reserves arise when projected net revenue is greater than projected benefits. In this situation, subsequent profits will be higher and the expected losses do not reflect a long-term deficiency.

- When revenue includes an interest margin, projected revenue may turn negative and a benefit ratio of less than 100 percent would result in expected losses in the years of negative revenue.

  Such losses result from investment activity and financial guarantees, not insurance features, and should not require loss recognition.

Also, calculations can be kept simple and the pattern of profits followed by losses mitigated by including negative revenue in the calculation of both the benefit ratio and the additional reserve.

Front-End Loads

Many people interpret existing standards to require deferral of any universal life load that is collected over a limited term. This sometimes leads to confusing or illogical results.

There are circumstances when even a temporary load should not be treated as a front-end load. Alternative treatment should be considered: (1) if the sum of expected temporary loads is greater than the sum of all acquisition costs; or (2) if URL amortization during the early years would exceed the temporary loads during those years.

In either case, the loads might more properly be accounted for among other assessments in an additional reserve calculation. In borderline situations, the difference between URL amortization and reserve accrual should be insignificant, making a sharp dividing line unnecessary.

Assessments and the Amortization of Unearned Revenue

Current standards amortize unearned revenue into assessments for the calculation of additional reserves. This should change. Front-end loads cannot be used both to recover acquisition costs and to fund contract benefits. Further, if amortization remains consistent with DAC then including it in revenue would complicate the reserve calculation and make results more difficult to explain.

Assessments and Interest on an Additional Reserve

Some interpretations of existing GAAP include interest spread from additional reserves in assessments. This is contrary to the notion that a liability is based on discounted product cash flows and makes the current reserve dependent on a projection of the reserve, adding significant inefficiency to the valuation.

Product cash flows should not include interest on an additional liability. (Interest spread on the policyholder account value, however, may remain a component of revenue without overly complicating the reserve calculation.)

Mixture of Retrospective Unlocking and Fixed Margin

The mixture of retrospective unlocking with an immediate approach for changes in discount rates could lead to either of two undesirable effects: (1) the process of maintaining both becomes needlessly complex; or (2) significant differences, unrelated to discount rates, could emerge after an assumption change if the immediate approach's net premium ratio were locked in at issue.

These can be avoided and the calculation can be made most efficient if the balance sheet liability uses the same cash flow projection and net premium ratio as the basic reserve calculation.

DAC Unlocking

Though not explicit in the board decisions, I understand that DAC amortization will use a prospective approach to unlocking. On the surface, this might seem to add complication—bringing a total of three different approaches to the unlocking process.

With the decision to amortize on amount in force, however, prospective DAC unlocking makes more sense than the alternatives. Any added complexity in the calculations should be minimal and its cost more than offset by the simplicity of explaining results.

As-of Date for Recalculating Net Premium (or Benefit) Ratio

The July 2015 decision about unlocking "as of contract inception" implies that everything should always be discounted to contract inception. Results of the unlocking, however, will be easier to explain if history is accumulated and projections are discounted to a current date. Further, some controls are strongest if there is a clear division between actual and projected experience; accumulating actual and discounting projected helps.

As long as the correct interest rate is used for accumulating and discounting the correct cash flows, the net premium ratio is independent of the date to which everything is accumulated or discounted.

Inception and the Fixed Discount Rate

A market-based discount rate fixed at inception of traditional cohorts could imply that new cohorts are needed whenever interest rates change. Such rigidity, however, could partly defeat the purpose of these changes.

Unless interest rates move significantly, practice should allow for aggregation of successive quarters. When considering interest rate changes, significance will likely vary by the anticipated premium pattern. At the extreme, single premium contract liabilities will be most sensitive to initial interest rates.

Timing of Unlocking

Many have expressed concerns about the restriction of unlocking to the fourth quarter.

Though there are benefits in limiting assumption changes to one quarter each year, prohibiting changes at other times can be problematic. Selection of the fourth quarter will be problematic for many.

Also problematic is the association of true up for experience variances with unlocking. This would force a delay between variances and their effects on reserves. Bad experience will look especially bad when it happens, and then sometime later we'll report a favorable offset. Similarly, good experience will look especially good when it happens, and then sometime later we'll report an adverse offset.

In this decision, I have been unable to find any real improvement without at least partial backtrack to a more dynamic standard. Though the board is considering a change, this remains something to watch.

OUTLOOK – DREAD AND OPTIMISM

Implications of these changes are varied, and observers have different opinions about the quality of the board decisions. For me, dread began with some of the first decisions. As I sought ways to lessen the damage, however, I began to see opportunity. Today, my dread comes from anticipating the transition effort and from considering how we might miss out on the practical benefits of change.

I believe we will find that seriatim valuation is no longer practical and cohort-level reserve calculations will become the norm. That will make transition especially challenging for traditional products. Lacking history in an appropriate level of detail will make precise transition practically impossible. Some forms of simplified transition will be essential. Even with simplified approaches, preparing valuation cohorts for decades of business in force will take significant time and effort. For many, mastering a new approach to valuation will also take time.

Conceptually, adapting universal life valuation systems to handle traditional products should not be difficult. Practically, however, many systems will have to be made much more efficient. A comprehensive system designed to handle all existing standards and multiple interpretations often needs more variables, more conditions, and more complex calculations than even the most complex interpretation of any standard. That makes it more inefficient than the most inefficient calculation.

My optimism comes from several benefits that I see in these changes. If we're successful in helping to shape the new standards and in implementing the standards:

- Valuation systems and processes will be more efficient. One projection will suffice for reserves, DAC recoverability, and shadow accounting. Product switches will tell the reserve which cash flows to use, but need not turn calculations on and off based on some ancient condition.
- Systems and processes will be consistent among products. Product expertise will be needed to understand product dynamics and to determine valuation inputs, but not to perform valuations.
- Reported product performance will be driven mostly by actual experience and much less by accounting differences. Explaining results can focus more on actual experience and less on accounting.

For these reasons, I see great opportunity in this project. That vision (along with the dread) has driven me to actively engage in this effort over the past year.

Turning optimism into reality, however, will require more than the concentrated efforts of a few accountants and actuaries. Critical thinking and many open minds searching for great answers rather than "the right answer," tempered by practical testing, may ensure that real improvement comes from "targeted improvements." ■

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