



Article from

Financial Reporter

December 2017

Issue 110

Accounting Change for Variable Annuities With Implications on Hedging

By Bruce Rosner and Robert Frasca

Actuaries who spend time working with variable annuities know that financial reporting for these products can be complex and sometimes frustratingly disconnected from their perceived economic values. This can lead to management decisions driven as much by accounting considerations as by the expected economic impact on the insurance company, sometimes hindering companies from hedging risks they might otherwise look to address. But change is on the way. The standard setters for U.S. statutory, US GAAP, and IFRS reporting are all taking steps to revise the accounting for variable annuities and the policyholder guarantees embedded within them. Though they vary by accounting basis, these changes are generally in the direction of reflecting current market conditions and include moving toward measures of current economic value.

At the same time, there has been a slight shift recently in companies' hedging preferences, away from a full economic hedge and toward protecting solvency capital. One potential outcome of the upcoming accounting changes is a shift back toward hedging of the economic exposures to guaranteed benefits.

US GAAP

Currently, there is a diversity in practice in how companies account for variable annuities under US GAAP. Companies uniformly record a base contract liability equal to the account value, but there is a split in the treatment of variable annuity riders. Guaranteed minimum death benefits, income benefits, and lifetime withdrawal benefits are often classified as insurance benefit features and consequently follow ASC 944-40-30 guidance (previously, and commonly, known as SOP 03-1). Guaranteed minimum accumulation benefits and non-lifetime withdrawal benefits are often classified as embedded derivatives and are recorded at fair value following ASC 815/820 (FAS 133/157) rules. Interpretations of classification may vary



by company as well, with companies assigning different classifications to seemingly identical benefits.

Companies often observe accounting mismatches when hedging guarantees fall under SOP 03-1 because the movements in the fair values of hedging instruments through profit and loss are not identically offset by the movement in the liabilities. Such mismatches can occur even when the liabilities are recorded at fair value due to elements in the definition of liability fair values, including the provisions for nonperformance risk and risk margins. In some cases, the perceived accounting anomalies discourage companies from hedging.

Targeted improvements proposed by the FASB, if adopted in their current state, will significantly alter this situation. The proposed guidance creates a new class of benefit features called “market risk benefits.” These benefits, which are guarantees made with reference to contracts backed by separate accounts, include all common guarantee riders currently found in variable annuities whether currently classified as SOP 03-1 insurance liabilities or embedded derivatives. The proposal would have all such guarantees recorded at fair value with changes recorded through profit and loss, except for changes in the provision for nonperformance risk, which would be recorded through

other comprehensive income. This proposal has its supporters and critics, with many people feeling that fair value is not an appropriate measurement basis for a long-term guarantee triggered only by an insured event (as is the case with a guaranteed minimum death benefit, for example). However, if adopted, this change will likely eliminate the diversity in practice currently observed across companies. It may also encourage more hedging of various guarantees by eliminating, or at least reducing, the mismatch in the measurement of hedge instruments and the liabilities being hedged.

IFRS

IFRS is the accounting basis required for public company financial reporting for Canada, most of Europe, and many other countries around the world. Most variable annuity contracts are classified as insurance contracts under IFRS, a consequence of guaranteed annuity purchase rates or other features that lead to insurance (mortality or longevity) risk within the contract.

Currently, insurance contract accounting is defined in IFRS 4. IFRS 4 has been authoritative since 2004 and was introduced as a stopgap measure to tide IFRS accounting over until such time as a permanent approach to insurance accounting could be developed. Essentially, IFRS 4 reverts insurance accounting back to the approach that had been applied prior to a company's adoption of IFRS as its accounting basis. For variable annuities written in the U.S., this frequently means US GAAP.

All of this is about to change. In May 2017, the IASB issued a new standard, IFRS 17, to replace IFRS 4 and to cover insurance accounting. Effective for annual periods commencing on or after Jan. 1, 2021, the standard fundamentally changes the accounting for all contracts classified as insurance, including variable annuities. The IFRS 17 standard for insurance contracts now provides a full framework for companies to follow. The standard is based on a foundation of insurance contract liability measurement that comprises two pieces: (1) "fulfilment cash flows," which represent the present value of the expected cash flows needed for the insurance company to fulfill its obligations under the insurance contract, plus a risk adjustment; and (2) a "contractual service margin" reflecting unearned profits the entity expects to earn as it fulfills its obligations under the contract in the future.

The standard also defines a special class of "insurance contracts with direct participation features," for which the insurance company is expected to pay the policyholder an amount equal to fair value of the underlying assets, less a variable fee that the company may deduct for providing services. The amount payable may also be increased due to the presence of various



contractual guarantees. The criteria for being classified as such a contract are defined more fully in the standard and, while it is by no means assured, many people believe that variable annuities will be considered insurance contracts with direct participation features and will follow a variation of accounting within IFRS 17 commonly known as the "variable fee" approach. Components of the contract classified as embedded derivatives, including certain guarantee features, will be treated separately and recorded at fair value.

The variable fee approach contains several distinguishing features. First, because of the direct linkage between underlying asset returns and the fulfilment cash flows, discount rates will likely equal projected growth rates on the underlying assets. This, in the absence of any contractual guarantees, yields a contractual service margin at issue equal to the present value of contract fees less expenses.

Second, the contractual service margin is adjusted to absorb any change in the fulfilment cash flows related to future services resulting from changes in the fair value of the underlying assets. Amounts representing return of the account value to the policyholder are excluded. This means that changes in the present value of future asset-based fees arising because of market movements are generally not reflected in the current earnings because they are directly offset through the contractual service

margin (provided the contractual service margin is positive). Similar treatment is applied to changes in cash flows on guaranteed benefit features.

Third, an entity may elect to **not** recognize changes in fulfilment cash flows in the contractual service margin for cash flows that are hedged, but rather have such changes flow directly to profit and loss in the period in which the changes take place. The election is subject to certain constraints related to the structure of the hedging program, but it appears that most dynamic hedge programs covering variable annuity guarantees would qualify for this treatment, and macro hedge programs could potentially qualify as well.

By providing the option to align liability movements with hedge values through profit and loss, IFRS 17 largely accommodates a company's decision process around whether to hedge. If a company chooses to hedge its exposure to guaranteed benefit cash flows, it can opt to have changes in cash flows reflected immediately in profit and loss, presumably matching the treatment of cash flows arising from hedging instruments. Hedge ineffectiveness will flow through profit and loss in each period as a natural consequence of the accounting treatment. There may be other sources of volatility, including the risk adjustment and the illiquidity premium in liability discount rates, that have no counterpart in the value of hedge instruments. Nonetheless, IFRS 17 would appear to enable a fairly broad recognition of hedge activity, potentially encouraging companies to hedge in cases where they might not have considered doing so under IFRS 4.

U.S. STATUTORY

While US GAAP and IFRS accounting may influence companies' hedging decisions, U.S. statutory accounting and risk-based capital (RBC) requirements are often more significant motivating factors for companies operating in the United States.

The NAIC introduced Actuarial Guideline 43 (AG 43) in 2009, which applied to the vast majority of variable annuities, both in force and new business. AG 43 requires two methods of valuation, and the final reserve is equal to the greater of the two:

1. **Standard Scenario Amount:** A single scenario following prescribed assumptions. The scenario itself is designed with a drop and recovery. The projection includes hedge cash flows for existing derivatives, but those derivatives are assumed to be liquidated after one year.
2. **CTE Amount:** A CTE 70 measure using real-world valuation principles. Hedge cash flows are also reflected, including

projected dynamic hedge behavior, modified by measures of hedge effectiveness.

C3 Phase II, which is the principle-based capital requirement introduced at year-end 2005, defines a similar standard for NAIC RBC for variable annuity guarantees.

Both AG 43 and C3 Phase II have provisions that affect reserves and capital requirements through the reflection of hedge activity within the reserve/capital calculations. Most notably, they both allow for some reflection of current hedge positions as well as future hedge activity when the company follows a clearly defined hedging strategy. These provisions are by no means complete, however. The reflection of hedge activity is limited by an effectiveness factor in the CTE Amount and by the requirement that hedges are all assumed to be liquidated within one year in the Standard Scenario Amount. Moreover, because the statutory reserve calculations incorporate real-world measurement concepts, they do not align with the market consistent valuation inherent in the fair values of hedge instruments.

AG43 and C3 Phase II currently generate reserve/capital requirements with varying degrees of sensitivity to market risks. For example, when the Standard Scenario Amount dominates, the reserve is not sensitive to changes in market interest rates. This discourages companies from hedging interest rates, as hedging has the potential to erode statutory capital when market interest rates increase. The NAIC and industry have recently proposed a number of changes to the methodology and are currently analyzing the implications.

Our attention is drawn to one specific proposal—to allow special treatment for any derivative that includes an interest rate hedge component—which is contained in the NAIC exposure draft “Issue Paper XX—Special Accounting Treatment for Limited Derivatives.”¹ Subject to a number of qualifications, any mismatches between the fair value of the interest rate hedges and the change in the AG 43 reserve could be amortized over a number of years, up to the duration of the liability. This potentially allows companies to enter into full economic hedges with substantially reduced concern that a mismatch

Changes are generally in the direction of reflecting current market conditions ...

between the timing of asset and liability movements will affect statutory capital.

THOUGHTS ON HEDGING

The changes across the accounting bases share one common theme—standard setters are increasingly aware of how integral hedging and risk management practices are to the management of variable annuity business and are adopting changes that enable financial reporting to reflect more closely the economics of the business when hedging is employed.

- US GAAP is poised to recognize all guarantees under variable annuities at fair value, providing a consistent measurement basis (fair value) and removing inconsistencies that may have impeded companies from more fully hedging market-based guarantees in the past.
- IFRS 17 enables consistency of treatment by offering the option to either align liability movements with hedge values through profit and loss or use the contractual service margin to absorb economic impacts on the liability.
- The proposed changes to AG 43 should dampen the balance sheet sensitivity to market movements when hedging is present, particularly with respect to interest rate risk. AG 43 reserves tend to have a relatively low sensitivity to interest rate risk, and companies will now have the option to fully hedge without concern that surplus may be affected by market movement.

The suite of risk management levers available for variable annuities includes product design, benefit pricing, in-force management, reinsurance and hedging. While we might like to think that all risk management activities are driven solely by economic considerations, the reality is that accounting impacts have significant sway in forming risk management policies.

Until now, hedging has played a more limited role than it might otherwise due to concerns about the way the economic benefits of hedging fail to manifest themselves reliably in the financial reporting bases. The proposals before the NAIC would appear to lessen volatility, thereby increasing predictability of capital funding requirements when guarantees are hedged. IFRS 17 and the tentative decisions on US GAAP changes lead in this direction as well, with earnings volatility and fluctuations in equity lessening under the influence of well-designed hedge programs. This will likely encourage companies to hedge guarantees more fully than they perhaps have done in the past. Participants in the variable annuity markets would be well advised to continue to follow these proposed changes through to adoption and to assess their impacts on risk management practices as they manage their businesses in these changing times. ■

The views expressed are those of the authors and not necessarily those of Ernst & Young LLP or other members of the EY organization.



Bruce Rosner, FSA, MAAA, is a senior manager at Ernst & Young LLP. He can be reached at bruce.rosner@ey.com.



Robert Frasca, FSA, MAAA, is an executive director at Ernst & Young LLP. He can be reached at rob.frasca@ey.com.

ENDNOTE

1 www.insurance.naic.org/documents/cmte_e_app_sapwg_exposure_2016_03_ip.docx