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Moving Away From Convergence

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For the past several years, the Financial Accounting Standards Board (FASB), which promulgates US GAAP accounting standards, has been working to converge the accounting standards on a number of topics with those of the International Accounting Standards Board (IASB), which makes the accounting standards for many other countries. Among these convergence projects were two of particular importance to actuaries: insurance contracts and financial instruments. However, over the past year the boards have decided to go their separate ways on both of these projects.

INSURANCE CONTRACTS

In February, FASB decided to stop pursuing a converged insurance contracts model with IASB. This means that it is no longer developing the building blocks approach (BBA) for long-duration contracts and the premium allocation approach (PAA) that were discussed in the exposure draft issued last year. Although IASB is continuing to develop that model, and expects to issue a new insurance contracts standard in 2015, FASB decided to pursue "targeted improvements" to existing US GAAP.

FASB began by addressing short-duration contracts. For short-duration contracts, it decided that the existing valuation model under FAS 60 did not require any changes. However, the board did decide to add some required disclosures. One of the key additional disclosures is a claim development table showing up to 10 years of claim development. It also required disclosure of both the frequency and severity of claims. To the extent claim liabilities are discounted, the effect of discounting will need to be disclosed.

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And FASB also decided to require disclosure of any changes in judgments used in determining the claim liabilities, including the reasons and impact of the changes. FASB was planning to release a final standard on short-duration contracts disclosure in late 2014.

In August, FASB turned its attention to long-duration contracts. For long-duration contracts the board had decided that changes were needed to both measurement and disclosure. Potential measurement changes it planned to discuss over the course of the project include:

- Unlocking assumptions for FAS 60 and FAS 97 limited pay contracts
- Discount rates
- Retrospective deferred acquisition cost (DAC) unlocking
- Loss recognition
- Possible changes to SOP 03-1 liabilities.

Unlocking Assumptions for FAS 60 and FAS 97 Limited Pay Contracts

At the August meeting, FASB discussed several of these issues, and made several key decisions. It decided that **assumptions and discount rates for FAS 60 and FAS 97 limited pay contracts would need to be unlocked.** This apparently also may apply to the reserve basis for participating contracts under FAS 120. The effect of the assumption changes would be reported in net income. The effect of the change in discount rates would also be reported in net income, rather than in other comprehensive income (OCI). Assumption unlocking would be required once per year. A company would not have the option of unlocking more often. And in order to increase comparability between companies, the decision mandated that **unlocking would be required to be performed in the fourth quarter.** There would be no flexibility on the timing of unlocking. This portion of the decision apparently also applies to unlocking DAC assumptions for FAS 97 universal life and FAS 120 contracts, assuming DAC unlocking is not eliminated in later discussions.

As a result of the decision to unlock all assumptions, there were a number of follow-up decisions. Provisions for adverse deviation (PADs) were no longer deemed necessary, and thus **FASB decided to eliminate PADs.** Also, **loss recognition was deemed unnecessary and thus eliminated for affected contracts.**

The decisions do leave some open issues, which may be addressed at future meetings. For example, when unlocking assumptions, is the net premium ratio locked in, or is that unlocked as part of the assumption change? If the net premium ratio is unlocked, is it unlocked prospectively or retrospectively? Unlocking the net premium ratio could mitigate some or most of the net income volatility from updating assumptions, depending on how the net premium ratio is unlocked. Also, would amortization of deferred profit liabilities for FAS 97 limited pay contracts be affected? If unlocking is required to be done once a year, can actual experience still get updated more often? Under current US GAAP, the reserve basis for FAS 120 participating contracts is based on the non-forfeiture or dividend fund basis, which never changes. So if the reserve basis is meant to be unlocked, does this signal that FASB intends to revise the FAS 120 reserve basis? And if loss recognition testing is eliminated, does this also mean that "gains followed by losses" testing is eliminated?

Discount Rates

FASB also discussed discount rates at the August meeting but did not reach a decision. The options being considered include using an asset book yield, consistent with existing FAS 60. But FASB is also considering whether a current yield curve, consistent with market conditions as of the valuation date, should be used instead. A current yield curve would be consistent with the proposal in the 2013 exposure draft, and also with the likely IASB standard. However, a current yield curve might also be more complex to apply, and could generate extreme volatility in net income if FASB retains its decision to report the impact of discount rate changes in net income. On the other hand, if FASB revises its decision and permits discount rate changes to be reported in OCI, a current yield curve could mean a more closely matched accounting basis for insurance contracts with available-for-sale assets. This would reduce the fluctuations in equity that currently occur in OCI due to changes in asset fair values. The accounting match would be even closer if the net premium ratio is not unlocked for changes in discount rates.

Next Steps

FASB has a number of further issues to discuss on long-duration insurance contracts, so it unlikely that it will be able to release an exposure draft of its positions until the second half of 2015. And then there will likely be re-deliberations to discuss comments submitted in response to its proposals. So we probably won't have a final standard on long-duration contracts until late 2016, if not later.

FINANCIAL INSTRUMENTS

FASB and IASB are also moving separately on their financial instruments standard. IASB released a final update to its financial instruments standard, IFRS 9, in July. The updated IFRS 9 covers classification and measurement, impairment and hedging. FASB has been nearing a final update to its financial instruments guidance as well.

On classification and measurement, it does not appear that too many changes will be made. Derivatives will continue to be reported at fair value, with all changes in fair value reported in net income (FV-NI). Embedded derivatives will continue to be bifurcated and reported at FV-NI. A fair value option will continue to be available for financial instruments that would otherwise be reported at amortized cost or at fair value with changes in value reported in OCI (FV-OCI). Originated loans will continue to be reported at amortized cost. For debt securities, the old FAS 115 categories will be retained, i.e.,

- Trading—reported at FV-NI
- Available for sale—reported at FV-OCI
- Held to maturity—reported at amortized cost.

There are a few important revisions, however. Equity investments will no longer be eligible to be classified as available-for-sale. Rather, most equity securities will be required to be reported at FV-NI. Also, for liabilities that apply the fair value option, the impact of "own credit" will be reported in OCI rather than in net income. There are also some changes to disclosure requirements.

On credit impairment, FASB has made significant modifications to the recognition of impairment on financial assets held at amortized cost. These assets will be subject to an allowance equal to the present value of all expected credit losses over the remaining life of the instrument, but limited by the fair value of any collateral. For assets reported at FV-OCI, the changes to the impairment model were more limited. Companies will no longer be required to consider how long the fair value has been less than amortized cost (i.e., whether the impairment is "temporary"), or any changes after the reporting date. Also, the board decided to permit previously recognized impairments to be reversed.

Although FASB seems close to final standards on classification and measurement and on impairment, a final standard revising hedge accounting seems to be far off. ■