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Exposure Draft of Targeted Improvements to Accounting for Long-Duration Insurance Contracts

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The Financial Accounting Standards Board (FASB) issued its exposure draft, or proposed US GAAP accounting standards update, on targeted improvements to accounting for long-duration insurance contracts on Sept. 29, 2016.[1] The exposure draft had about a 75-day comment period, so comments were due by Dec. 15. Organizations that submitted a comment letter by the due date would be eligible to participate in a roundtable discussion with FASB on the topic on March 15, 2017. The American Academy of Actuaries Financial Reporting Committee submitted a comment letter that was largely supportive of the proposed targeted improvements, but pointed out some problems that needed to be fixed as well as suggestions to improve the proposal further.

EXPOSURE DRAFT FORMAT

This exposure draft had a somewhat different format than proposed insurance accounting changes in the past. In the past, new accounting standards were developed to address particular issues and the exposure drafts and final standards basically provided the (proposed) accounting approach for the issue(s) in question. This was the format of such standards as FAS 97 and FAS 113 and also guidance put out by the AICPA, such as SOP 03-1.

In 2009, FASB completed their project to codify US GAAP. Under this project all relevant accounting guidance was consolidated into one document, which was organized into topics, such as insurance, revenue and fair value. The guidance from previous FASB standards, as well as other guidance that was to be retained, such as SOPs, was absorbed into this document. Insurance accounting guidance was now considered to be Topic 944 within Accounting Standards Codification. Statements such as FAS 60 FAS 97, SOP 03-1 became obsolete, but their guidance was now consolidated within Topic 944.

This had an impact on the format of subsequent exposure drafts and new accounting standards. Subsequent to codification, exposure drafts and new accounting standards were essentially red-lined or track changes versions of the accounting codification topic in question. The 2013 insurance contracts exposure draft was an exception because the proposal was to scrap Topic 944 entirely and replace it with a brand new topic. But because FASB decided to pursue targeted improvements, the 2016 exposure draft followed the typical new format of showing the relevant portions of Topic 944, crossing out portions to be deleted and underlining new language to be inserted.

EXPOSURE DRAFT PROPOSALS

The main proposals of the exposure draft would probably not be a surprise to those who have been following this project for the past two years. The main proposals were to:

1. Unlock reserve assumptions for traditional contract liabilities, including non-participating limited-payment and participating contracts. Assumptions would be reviewed at least annually and the net premium ratio would be unlocked retrospectively to account for changes in projected cash flows, subject to a cap of 100 percent. Provisions for adverse deviation, loss recognition testing and profits-followed-by-losses testing would be eliminated for these contracts.

2. Update the discount rate for traditional contract liabilities, including non-participating limited-payment and participating contracts each reporting period using a current market "high-quality fixed-income instrument rate." The effect of changes in discount rate would be reported in other comprehensive income (OCI).

3. Simplify DAC amortization, either in proportion to in force or straight-line. There would be no DAC impairment test.

This amortization approach would also apply to other items that amortize like DAC, such as unearned revenue liabilities and deferred sales inducements.

4. Market risk benefits, which are essentially guarantees on variable contracts, would be reported at fair value. Changes in fair value would be reported in net income, except for changes due to changes in own credit which would be reported in OCI.
5. In lieu of profits-followed-by-losses testing for account balance products, there would need to be determination of whether an additional liability for annuitization, death or other insurance benefits (i.e., an SOP 03-1 liability) is needed subsequent to issue. Currently such determination is made only at issue. If an SOP 03-1 liability is needed subsequent to issue, it would be accrued retrospectively (i.e., the balance that would have accrued since issue would be reported as of the date the determination was made that an SOP 03-1 liability was needed).
6. Many additional disclosures would be required, such as rollforwards of liabilities and information about assumptions and inputs.

There were a few details that I was surprised about when reading the exposure draft. I was surprised that FASB retained the option to lock-in the discount rate used for calculating SOP 03-1 liabilities at contract inception. I had assumed that we would be required to update this discount rate each reporting period, similar to traditional contract liabilities, even though the discount rate used for SOP 03-1 liabilities is different than that for traditional contract liabilities.

I was also surprised that there was a provision stating that reinsurance of market risk benefits would be fair valued, consistent with the direct benefit. I think this makes sense in most situations, since it avoids an accounting mismatch between the direct benefit and the ceded benefit, but I don't think that was clear from the original deliberations.

AMERICAN ACADEMY OF ACTUARIES COMMENT LETTER

The Financial Reporting Committee of the American Academy of Actuaries submitted a comment letter on Dec. 15.[2] The letter was largely supportive of the FASB proposals for targeted improvements. The letter did note that the committee would have preferred a more comprehensive approach to improving accounting for long-duration insurance contracts, along the lines proposed in 2013, and expressed hope that FASB would be willing to consider such an approach in the future. But the committee agreed that given the direction of the project to provide targeted improvements to existing GAAP, FASB addressed the most important issues and that their proposals were generally beneficial.

The committee agreed that updating assumptions and discount rates for traditional contracts and reporting market risk benefits at fair value would make the reported information more relevant. The committee agreed that simplified DAC amortization would be easier for users to understand and reduce costs for preparers. And the committee agreed that most of the enhanced disclosures would be beneficial to financial statement users.

FASB retained the option to lock-in the discount rate used for calculating SOP 03-1 liabilities at contract inception.

The committee did point out two significant flaws with the proposal. One of the flaws related to participating contracts. Under the proposal, participating contracts would use the same liability valuation model as non-participating contracts. This would be a problem because the non-participating contracts model assumes a locked-in credited rate, and so doesn't take into account the fact that the credited rate of participating contracts varies as expected investment experience changes. Addressing this would require several changes to the proposed model for participating contracts. The proposed model also does not seem to account well for the fact that expected dividends on participating contracts sold by mutual companies may include expected future profits from non-participating businesses.

The other significant flaw noted by the committee related to retrospectively accruing an SOP 03-1 liability subsequent to issue in lieu of existing profits-followed-by-losses testing. The main concern was that the retrospective accrual would not only accrue for the present value of future losses, but would also retroactively change the profit recognition pattern. An example in the letter demonstrated that this can produce an SOP 03-1 liability accrual that is larger than the expected future losses, which the committee did not believe would be appropriate. The committee was also concerned that requiring such retrospective accruals would mean that a company would always have to be prepared to put up such a reserve on any universal life-type contract. Since the SOP 03-1 calculation is very similar to the current universal life DAC calculation, this would minimize the practical benefit of simplifying DAC amortization.

The committee also made a number of suggestions to improve the proposal further. A key suggestion was to unlock the net premium ratio prospectively rather than retrospectively when

assumptions were changed for traditional or SOP 03-1 liabilities. The committee suggested that retrospective unlocking, which is the approach used when updating universal life DAC assumptions today, would be difficult for users to understand and would be operationally burdensome. The committee noted that prospective unlocking would be consistent with the approach the International Accounting Standards Board (IASB) is taking towards updating assumptions and would thus enhance convergence.

The committee also suggested revising the language used to determine the discount rate for traditional contracts. The committee's concern was that "high-quality fixed-income instrument rate" is used in other areas of US GAAP, such as pension accounting, and has been interpreted as requiring a AA rate or better. The committee was concerned that this would not provide an adequate illiquidity premium for most insurance contracts.

Another suggestion was that for closed blocks formed on demutualization, a simplified valuation would be less burdensome for preparers and more reflective of the economics of the contracts. This would recognize that all closed block asset returns would eventually be passed through to the closed block policyholders. So the liability could simply be equal to the asset book value, plus an additional liability in the event the assets are expected to be insufficient to cover liability guarantees.

The committee also suggested that FASB consider changes to the definition of a market risk benefit to increase consistency among similar benefits. For example, some equity indexed contracts could provide very similar cash flows to variable contracts, but guarantees on such equity indexed contracts would not be considered market risk benefits, and thus not necessarily be reported at fair value. The committee also suggested possibly reconsidering whether death benefits should be considered market risk benefits.

Another suggestion was to consider amortizing unearned revenue liabilities on universal life-type contracts consistent with deferred profit liabilities on limited payment contracts, rather than like DAC. This is because both unearned revenue and deferred profits represent deferred revenue, and so it may be appropriate to account for them consistently. The committee also suggested possible simplifications to the disclosure and transition requirements.

NEXT STEPS

As of Dec. 20, 2016, FASB had received 38 comment letters on the exposure draft. This included comments from insurance companies and accounting firms, as well as organizations such as the Academy, the ACLI and the AICPA. The next official step in this process is likely to be a roundtable discussion at the FASB offices on March 15 in which preparers, auditors and investors will discuss their positions on the proposals with FASB board members and staff. FASB is likely to have several meetings in 2017 to redeliberate aspects of the proposal that drew concerns or suggestions in either comment letters or the roundtable discussion. My understanding is that FASB would like to complete this project and issue a final standard by the end of 2017. ■

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ENDNOTES

1 *http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168477111&acceptedDisclaimer=true*

2 *http://www.actuary.org/files/publications/Academy_FASB_Long_Duration_Contracts_Comments_12142016.pdf*