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FASB Deliberations on Accounting for Assumption and Discount Rate Changes

By Leonard Reback

The Financial Accounting Standards Board (FASB) met on May 21, 2015 to discuss its ongoing project to make targeted improvements to accounting for long-duration insurance contracts. The meeting was an education session, with no decisions made. However the Board appeared to narrow its choices as to how to implement previous decisions to update assumptions and current market discount rates for FAS 60, FAS 97 limited-pay and SOP 03-1 reserves.

The Board initially discussed four possible options for how to handle the net premium ratio (or benefit ratio for SOP 03-1) when reserve assumptions or current market discount rates are revised:

1. Lock in the net premium ratio—Under this approach the net premium ratio calculated at issue would remain locked in. To the extent the change in cash flow assumptions or discount rates causes the present value of future cash flows to change, the full amount is reflected in the change in reserves and in net income.
2. Prospectively unlock the net premium ratio—Under this approach the net premium ratio is unlocked as of the time of the cash flow assumption or discount rate change to the extent of the change in present value of future cash flows. Under this approach, assuming there are future premiums to be paid in the contract, there is no immediate impact to the reserve or to net income (at least if there is no premium deficiency). The full impact of the change emerges over future periods.
3. Retrospectively unlock the net premium ratio—This approach is somewhat intermediate between (1) and (2), and is similar to the way DAC is unlocked today for universal life-type contracts when assumptions change. Under this approach, the net premium is unlocked as if the cash flow assumption or discount rate change was known at the time the contract was issued. Assuming there are future premiums to be paid in the contract, some of the impact of the assumption or discount rate would impact the reserve and net income, while the remainder would revise the net premium ratio and emerge over time. More of the impact would flow through the reserve immediately for older contracts than for newly issued contracts.

   Retrospective unlocking would also presumably require truing up actual experience as it emerges differently than previous assumptions. Again, this is similar to universal life DAC calculations. Such truing up could mitigate volatility from actual experience deviations, which some may view positively (under a viewpoint that less income volatility is good) and others may view negatively (under a viewpoint that the full impact of actual experience should be reflected in income). Such truing up would likely significantly increase the cost of implementation, as it would essentially require all the current universal life DAC amortization mechanisms (creating cohorts, tracking experience, allocating experience deviation to cohorts) to be applied to FAS 60 contracts.
4. Prospectively unlock the net premium ratio for cash flow assumption changes but lock in the net premium ratio for discount rate changes—for some reason, this split approach was not discussed with retrospective unlocking for assumption changes.

During the discussion, a fifth approach came up. Under this approach, the net premium ratio would be locked in for purposes of reporting the reserve on the balance sheet, but retrospective unlocking would be used to determine net income. The difference between the two calculations would be reported in other comprehensive income (OCI).

Neither prospective unlocking approach (with or without locking in the net premium ratio for discount rate changes) seemed to gain any traction with the Board. So staff seems to be focusing on and further developing the other three approaches:

a. Lock in net premium ratio for all changes;

b. Retrospectively unlock net premium for all changes; and

c. Lock in for all change on balance sheet, retrospectively unlock for net income, with the difference through OCI.

POSSIBLE EFFECTS OF THESE APPROACHES

For cash flow assumption changes, I think any of these approaches can be justified, although they have different costs and impacts to the financial statements. Lock in is probably the most practical to implement, while retrospective unlocking is probably the least practical, especially if true ups are required. Lock in would create the most income volatility when assumptions change.

However, for discount rate changes I think all of the approaches that seem to be under consideration have significant issues.

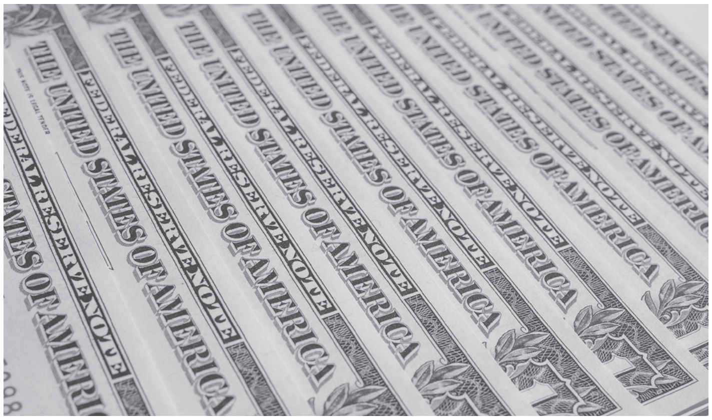
Lock in approach

Under the lock in approach, net income could become very volatile. The full impact of assumption and discount rate changes will impact the reserves on the balance sheet through net income. In some instances, a large loss could be shown in the current period for profitable products. That could be the case when there is an assumption or discount rate change that is adverse to the insurer, but not so severe as to wipe out all future profits. In that case, the full present value of the future cash flows from the change will be reported in net income currently, and the previously estimated profits will flow unaltered through net income in the future.

A benefit of this approach is that there may be a better match on the balance sheet between the fair value of invested assets and the liability discounted at a current discount rate. However, if the assets and liabilities are not very closely matched, this could result in significant volatility to net income. During the joint project between the IASB and FASB that led to the 2013 exposure draft, these impacts would have been reported in OCI.

Retrospective unlocking approach

Under a retrospective unlocking approach, there would be some offset to the impact of assumption changes, mitigating volatility to some extent. Retrospective unlocking would also mitigate volatility to the liability value from changes in discount rates. However, this is not necessarily desirable. Even after retrospective unlocking, a change in current market discount rates could still have a very large impact to the liability. But this impact would be smaller than the impact to fair value of a perfectly matched



asset portfolio. So the impact to the liability from changes in discount rates would not match income from assets on either an amortized cost basis or a fair value basis. There is no asset measurement model that would be consistent with retrospective unlocking. Thus, there would be substantial net income and balance sheet volatility resulting from this accounting mismatch, even to the extent there is a perfect economic match between assets and liabilities.

Retrospective unlocking for net income/Lock in for balance sheet

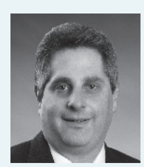
Using a hybrid approach may appear to address some of the concerns from using a pure retrospective unlocking approach or a pure lock in approach, but I do not think it does. There would be some benefits to such an approach. To the extent the assets and liabilities were economically matched, and to the extent the assets could be reported at fair value on the balance sheet, this approach would achieve the benefits of the pure lock in approach of matching the asset fair values with liability values on the balance sheet. And this approach would mitigate some of the net income volatility from assumption changes, as per the pure retrospective unlocking approach. But this approach would still use retrospective unlocking for changes in discount rates when reporting net income. So we would still have potentially huge volatility to net income from mismatched accounting bases between assets and liabilities.

Other possibilities

Hopefully, FASB will recognize the issues created by the options currently on the table and will consider alternatives (perhaps by the time you read this). I hope they will consider solutions in which assumption changes and discount rate changes are treated differently. At the meeting, some Board members expressed practical concerns about splitting these effects (for example, a change in mortality assumption may impact the liability duration), but I don't think these should be particularly difficult to separate for FAS 60 or FAS 97 limited pay contracts in particular, and any interaction effects are likely to be small. If they consider applying different treatment to assumption changes versus discount rate changes, that could permit them to unlock the net premium ratio for assumption changes (mitigating some volatility) while locking it in for discount rate changes (mitigating accounting mismatches with asset fair values). And since they seem to be willing to consider OCI, if they do lock in the net premium ratio for discount rate changes, perhaps they will permit the impacts to flow through OCI, avoiding much of the volatility from discount rate changes if assets and liabilities are not perfectly matched. ■

ADDENDUM

At their meeting July 24, 2015, FASB addressed these issues. FASB's tentative decision on discount rate changes was to lock in the net premium ratio, with the impact of the change reported in other comprehensive income (OCI). The tentative decision on other assumption changes was to retrospectively unlock the net premium ratio, with the impact reported in net income. The retrospective unlocking would cover truing up actual versus expected experience deviations. All reserve changes, whether from discount rates, assumption changes, or experience, would only be reported in 4th quarter.



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