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FASB Insurance Contracts Disclosures and Transition

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The Financial Accounting Standards Board (FASB) continued its deliberations on targeted improvements to GAAP accounting for long-duration insurance contracts in February and March. The meetings focused on presentation, disclosure and transition issues.

Perhaps the most important issue addressed at these meetings was the least surprising; FASB officially confirmed that they will be drafting an exposure draft, rather than a final standard. This means that there will be an opportunity to formally comment on FASB's tentative decisions, and that FASB will likely redeliberate some issues in light of those comments. Because FASB had already issued an exposure draft on insurance accounting in 2013, it was not obligated to issue another exposure draft. But given its pursuit of targeted improvements rather than a converged model with IASB, it was widely expected that FASB would issue an exposure draft on its targeted improvements rather than go straight to a final standard.

Although the board appears to have completed its substantive discussions on targeted improvements, FASB did suggest that it would continue to look at issues that the industry has raised about the tentative decisions on participating contracts.

CLARIFICATION ON SCOPE OF SOP 03-1

Although the disclosure meeting did not address valuation or measurement issues, some of the new disclosures suggest a change to insurance contract valuation that may not have been clear from previous meetings. Some of the new disclosures for SOP 03-1 liabilities imply that even if an SOP 03-1 liability was not required when the contract was issued, the company would be required to continually monitor whether an SOP 03-1 liability becomes necessary subsequent to issue, due to expected future losses. This would be a change from existing GAAP, where the assessment of whether an SOP 03-1 liability is needed is performed only at contract issue.

Apparently, this ongoing assessment of the need for an SOP 03-1 liability would replace existing loss recognition and profits-followed-by-losses guidance for non-traditional contracts. It seems likely that if an SOP 03-1 liability is needed after inception, the calculation would be done retrospectively from issue, similar to previous FASB tentative decisions that net premium ratios and deferred profit liabilities would be updated retrospectively upon assumption changes on traditional contracts.

CLARIFICATIONS ON DAC AMORTIZATION

FASB did provide some clarifications about their tentative decisions on DAC amortization. This was in response to industry questions about how DAC amortization would work, especially since the board's tentative decisions do not make any allowance for a DAC recoverability test as we have today.

Under the tentative decisions, DAC would be amortized over the expected life of a contract in proportion to amount in force, or in some cases via straight line. No interest would be accreted on DAC. FASB clarified that when unexpected contract terminations occur, there should be an immediate proportionate write down of DAC. This will prevent DAC from persisting when there are no contracts in force to support the DAC. FASB also clarified that when assumptions about expected life of the contracts change, DAC amortization should be adjusted prospectively. This means that the DAC balance should not change immediately, but rather the future amortization schedule should be revised.

FASB continued to insist that with these clarifications, no additional recoverability testing is needed. This means that even if the portfolio of contracts has a net premium ratio of 100 percent, i.e., all expected future premiums will be used to pay expected future benefits and expenses, there can still be a separate DAC asset held for those contracts.

At the February meeting, FASB decided to add additional footnote disclosures to the financial statements.

In a separate clarification, FASB noted that only DAC amounts that have already been accrued would be amortized. Today we amortize DAC based on previously accrued amounts plus amounts expected to be accrued in the future for deferrable renewal acquisition costs. But since the tentative decisions eliminate present value considerations from DAC amortization, i.e., accruing interest, the board felt that it no longer would make sense to include future expected accruals in current period amortization. Instead, amortization would increase after those costs have been incurred and accrued as DAC.

PRESENTATION

The only element of financial statement presentation that was revised was for variable contract guarantees with other-than-nominal capital market risk. FASB now refers to these guarantees as "market risk benefits." At a previous meeting FASB decided that market risk benefits should be reported on the balance sheet at fair value, and that all changes in fair value except changes due to own credit should be reported in net income. At the February meeting FASB tentatively decided that the fair value of market risk benefits should be shown in a separate balance sheet line item. It also tentatively decided that the change in fair value should be shown in its own line in the income statement.

DISCLOSURES

At the February meeting, FASB tentatively decided to add numerous additional footnote disclosures related to insurance contracts to the financial statements. These would be required for both annual and quarterly financial statements. The new requirements were separated by different types of assets and liabilities. All types of liabilities, including FAS 60, FAS 120 and SOP 03-1 reserves, policy account balances (including separate accounts), and market risk benefit liabilities would be required to show disaggregated tabular rollforwards from beginning balance to ending balance. Such a rollforward would also be required for deferred acquisition cost (DAC) assets. It was not explicit whether such a rollforward would be required for balances that amortize similarly to DAC, such as deferred sales inducement assets and unearned revenue liabilities.

The individualized disclosures by liability type are as follows.

Future Policy Benefits (FPBs)

Future policy benefit liabilities, including FAS 60, FAS 120 and SOP 03-1 reserves, would be required to disclose the following:

- The tabular rollforwards would be required to show separately expected future net premiums and expected future benefits.
- Undiscounted values of expected future net premiums and benefits associated with each rollforward.
- Amount of gross premium recorded and amount of any reinsurance recoverable associated with each rollforward.
- Information about significant estimates, judgments, inputs and assumptions for each rollforward. This would include narrative descriptions, including the effect of any changes. It would also include quantitative information about assumptions, such as the range, the weighted average, and how it compared to actual experience.
- Reconciliation of the rollforward amounts to the ending liability balance, interest and gross premium shown in the financial statements.
- Qualitative and quantitative information about situations where the net premium ratio exceeds 100 percent or where an SOP 03-1 liability has to be established subsequent to policy inception.
- Information about estimates, judgments and assumptions used to determine that no SOP 03-1 liability is needed because no future losses are expected. This information is similar to the information that would be provided about estimates, judgments and assumptions in the liability calculation itself.

Policyholder Account Balances (PABs)

Policyholder account balances on non-traditional contracts would be required to disclose the following:

- Net amount at risk and cash surrender value associated with each rollforward.
- Weighted average earned rate and weighted average credited rate associated with each rollforward, as a measure from which readers could estimate spreads.
- Reconciliation of the rollforward amounts to the liability balance in the balance sheet.
- Table of account balances showing ranges of guaranteed credited rates, and the associated range of excess of current credited rate over guaranteed rate.
- Information about risk management.

Separate account balances would only need to show the cash surrender value and the reconciliation between the rollforward and the balance sheet amount.

Market Risk Benefits

Market risk benefits would be subject to standard fair value disclosures. But there would be modifications to the standard fair

value rollforwards to be more relevant to insurance contracts. There would also be additional disclosures including:

- Net amount at risk and fees collected associated with each rollforward.
- Information about estimates, judgments and assumptions, including effects of changes and weighted averages, ranges and comparisons to actual experience for assumptions.
- Reconciliation of the rollforward amounts to the ending liability balance. This would need to be shown separately for guarantees that are in-the-money and those that are out-of-the-money.
- Information about risk management.

TRANSITION

FASB's tentative decisions were as follows:

Future Policy Benefits

For reserves for future policy benefits, such as FAS 60, FAS 120, FAS 97 limited pay, and SOP 03-1, FASB tentatively decided that the revised valuation should be applied retrospectively back to contract issue. This would mean calculating a net premium ratio for the contracts as of the transition date that takes into account all actual cash flows the contracts have experienced since issue, current discount rates as of the transition date, and current assumptions as of the transition date. Other comprehensive income (OCI) upon transition would be calculated based on the difference between the reserve using current discount rates as of the transition date and the reserve using the discount rates that would have been in effect (in accordance with FASB's tentative decisions) as of the contract issue date.

FASB recognized that this may be impractical for companies to do for all contracts, particularly for contracts that may have been issued decades ago. So, FASB is permitting the retrospective calculation to incorporate estimates of historical information if needed, as long as the estimates are based on objective information.

If even such estimates are not available all the way back to contract issue, the liability as of the transition date would be set equal to the liability under current US GAAP. If the resulting net premium ratio exceeds 100 percent, a loss would be reported to opening retained earnings to the extent of the excess.

Since the transition would be performed on a cohort-by-cohort basis, different cohorts may use different approaches to set the opening reserve upon transition.

Market Risk Benefits

FASB tentatively decided to measure market risk benefits at fair value as of the transition date. Any impact to fair value resulting from changes in own credit between the issue date and the transition date would be recorded in accumulated OCI. It was not clear from the tentative decision what, if any, practical expedients would be permitted for determining the "attributed fee" for the market risk benefit.

DAC

FASB tentatively decided that the DAC balance as of the transition date should be unchanged from current US GAAP, and the revised amortization guidance should be applied only prospectively after the transition date. ■

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