



Article from  
**Financial Reporter**  
September 2017  
Issue 110

# Industry Preparedness And Impact of FASB Targeted Improvements

By Craig Reynolds and Karthik Yadatore

**T**he Financial Accounting Standards Board (FASB) released an exposure draft on Sept. 29, 2016, in which it proposed significant changes to U.S. GAAP accounting for long-duration insurance contracts to address stakeholders' key concerns. We have summarized the proposed changes below:

1. Unlock and periodically update benefit and expense reserves for fixed premium/ fixed benefit products.
2. Amortize deferred acquisition cost (DAC) in proportion to insurance or benefits in force, without interest, and eliminate loss recognition testing.
3. Use fair value methods to calculate reserves for all guarantees associated with separate account products.
4. Provide detailed disclosures on liability balance roll-forwards.

We recently performed a detailed study<sup>1</sup> to understand:

- The impact of the proposed changes to GAAP earnings and equity for several illustrative product types and
- Industry's key concerns, preparedness to adopt, and expectations of impact of the proposed changes via a survey of 14 leading life insurance and annuity producers.

In the remainder of this article, we highlight the results of our study. While the terms such as FAS 60, FAS 97, FAS 120, and SOP 03-1 are technically no longer in use, we use them in this article because they are a part of the common vernacular.

## UNLOCK AND PERIODICALLY UPDATE BENEFIT AND EXPENSE RESERVES FOR FIXED PREMIUM/ FIXED BENEFIT PRODUCTS

One of the key stakeholder concerns is the need to improve the timeliness of reflecting emerging experience and its deviation from expected when calculating the liability value.

To address this concern, FASB has proposed that the net premium reserve method will continue to apply. However, the net premium ratio will be updated at each valuation date for actual historical experience and any updates to the projected best estimate cash flows. The assumptions used to project the best estimate cash flows must be updated at least annually and will not contain any provision for adverse deviation (PADs). The discount rates used to calculate the reserves will be based on the yields of high-quality fixed investment income assets that reflect the duration characteristics of future policy benefits. The discount rate must be updated at least quarterly.

The proposed changes are in contrast to current GAAP where, in the absence of loss recognition, the assumptions, including the discount rate, are locked-in at issue. Hence, the reserve factors too are locked-in at issue.

The proposed changes will impact products that fall under the purview of FAS 60, FAS 120, and FAS 97 Limited Pay. Our survey results show that the industry largely agrees with this change in principle. However, 12 of the 14 survey participants are concerned about the unlocking of liability cash flows when reserving for fixed premium/ fixed benefit products, primarily for two reasons: 1) difficulty in implementation due to resource constraints, and 2) possible material impact to GAAP equity and income. In particular, nine participants expressed concern about possible material impact to GAAP financials due to a nonalignment of discount rates and the earned rates. We believe that resource constraints arise due to possible lack of historical information for these products along with possible valuation/financial system changes required to implement the proposed changes.

To illustrate and analyze potential impacts of the proposal, we modeled a 20-year term product on a new business basis and a seasoned participating whole life (par WL) block and performed various sensitivities to simulate change in model assumptions or deviation of actual from expected. The par WL's dividend scale is dynamically adjusted based on the projected earned rates, mortality rates and expenses. The results of our modeling lend validity to the industry concerns.

Due to the elimination of PADs, the term product's reserves are lower when calculated under the proposed changes compared with reserves under current GAAP. An increase in the mortality and expense assumption or a decrease to the projected earned rates have a more muted impact on GAAP reserves under current GAAP where the reserve factors are locked-in. However, under the proposed changes, the reserves significantly increase when adverse experience leads to changes in future assumptions, since reserve factors are updated for increase in prospective mortality and expenses or a decrease to current or assumed future earned rates. Under current GAAP, when deviation of ac-

tual experience from expected occurs during the current period, almost the entire amount of the variance affects GAAP income immediately, whereas under the proposed changes, some of the variance would be offset by a corresponding update in the liability calculation.

For the par WL product, since the reserve factors under current GAAP are locked-in at issue, the reserves are relatively unchanged when mortality or expense assumptions are increased. Interestingly, under the proposed changes too, the reserves remained largely unchanged because the dividend scales reflected in the best estimate cash flows were assumed to adjust to reflect changes in anticipated experience.

Under the proposed changes, we believe that the standard would require the discount rate to be based on an AA-quality yield curve, since the wording in the exposure draft is the same as is used for pension obligations, and for those the Securities and Exchange Commission (SEC) has deemed “high-quality” to be AA. Due to this proposed change to discount rate assumption, a disconnect will likely exist between the earned rates that feed into the dividend scale and discount rates. Hence, liability measurement could be understated or overstated relative to what would be needed to fund the benefits and anticipated dividends.

### AMORTIZE DEFERRED ACQUISITION COST (DAC) IN PROPORTION TO INSURANCE OR BENEFITS IN FORCE

FASB has proposed that DAC now be amortized in proportion to insurance in force as opposed to premiums, estimated gross profits (EGPs), or estimated gross margins (EGMs) to address the stakeholder concern of simplifying DAC amortization. The DAC asset will not accrue interest and loss recognition will be eliminated. The net premium ratio and the SOP 03-1 benefit ratio will be capped at 100 percent.

Ten of the 14 survey participants believe that simplification of the DAC amortization is one of the main improvements resulting from the proposed changes. We asked the survey participants what they intended to use as a basis for amortizing the DAC for various products. For whole life and term products, the preferred choice is death benefit in force, followed by policy count. For both variable and general account universal life, the preferred choice is death benefit in force, followed by policy count and account value. For deferred annuities, the popular choice is account value, followed by policy count, and for immediate annuities and structured settlements, the preferred choice is annuity benefits in force, followed by policy count.

We also modeled a universal life (UL) and a fixed deferred annuity (FDA) to understand the impact of the proposed changes to DAC amortization.



For the term and the par WL products, we used the face amount in force to amortize the DAC under the proposed changes. For both these products, DAC is amortized at a faster rate compared with current GAAP due to the absence of interest rate accrual. For term, the impact of the removal of interest accrual on DAC is much more significant than the removal of PADs. For UL products we used face amount in force, and for the FDA we used account value as the basis of amortization under the proposed changes. Our modeling results show that, under the proposed GAAP, for par WL, UL and FDA, the amortization basis, and hence DAC, tends to be less sensitive to change in assumptions or deviations of actual from expected compared with the amortization basis and DAC calculated under current GAAP. Unlike the term and par WL product, the DAC balance calculated under the proposed changes for UL and FDA would not always be lower than DAC calculated under current GAAP. This is because the projected EGPs can increase or decrease from one projection period to the next, while the amortization basis under new GAAP, e.g., death benefit in force and account value, generally would tend to decrease after the contract was past the premium paying period.

### USE FAIR VALUE METHODS TO CALCULATE RESERVES FOR ALL GUARANTEES ASSOCIATED WITH SEPARATE ACCOUNT PRODUCTS

FASB has proposed this change to simplify the accounting associated with options and guarantees embedded in variable



products. The impact of this proposed change will mostly impact variable annuity products. Under current GAAP, guaranteed minimum death benefits, income benefits, and sometimes withdrawal benefits are accounted for under SOP 03-1, as they involve longevity or mortality risk. Fair valuing these benefits will add significant volatility to the GAAP liability.

Half of the survey participants expressed concern about fair value reserving for all GMxBs due to the possible materiality of impact to GAAP financials. Our understanding is that this proposal may:

- Create incentives for companies that don't hedge their guaranteed minimum benefits to reevaluate their hedging strategy and philosophy;
- Better align the hedge target and the liability value for companies that hedge the economic value of these guarantees; and
- Continue to produce a mismatch between the hedge gains/losses and the change in GAAP liability value for companies that hedge their statutory reserving and solvency requirements, though the mismatches may now be different in direction and magnitude due to the proposed changes.

## IMPROVED DISCLOSURES

FASB will propose significantly more involved disclosure requirements than currently required to improve the effectiveness of required disclosures and provide more decision-useful information to financial statement users.

Disaggregated roll-forwards of the liability balances will be required along with information about estimates and judgments, including how they have changed and their effect on the measurement of the liability. For account value-based products, balances will need to be presented based on ranges of combinations of minimum guaranteed rates and current credited rates.

All 14 participants responded that they do not have an existing process or a clear plan in mind to produce the required attribution, disclosures and documentation. A combination of a need for additional resources and perceived ambiguity about the proposed changes is causing almost all of the survey participants to be concerned about required attribution, disclosures, and documentation and the transition guidance.

## CONCLUSION

Based on the results of our modeling, we conclude that the changes proposed by FASB may have significant impact and require material implementation effort. However, our survey results show that the industry has completed almost no work beyond discussing the proposed changes with senior management. We hope that this article and the white paper we published will shed more light on understanding the impact of the proposed changes and prompt further discussion. ■



Craig Reynolds, FSA, MAAA, is a principal and consulting actuary at Milliman Inc. He can be contacted at [craig.reynolds@milliman.com](mailto:craig.reynolds@milliman.com).



Karthik Yadatore, FSA, MAAA, is a consulting actuary at Milliman Inc. He can be contacted at [karthik.yadatore@milliman.com](mailto:karthik.yadatore@milliman.com).

## ENDNOTE

- 1 <http://www.milliman.com/insight/2017/Proposed-Changes-to-US-GAAP-An-impact-analysis-of-proposed-targeted-improvements/>