Article from

The Financial Reporter

March 2016
Issue 104

FASB Update—Q4 2015

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The Financial Accounting Standards Board (FASB) has continued to deliberate its targeted improvements to GAAP accounting for long duration insurance contacts in the fourth quarter of 2015. FASB made a number of important tentative decisions, some of which I believe were very positive and responsive to concerns raised by actuaries, while other decisions were more problematic. It appears that FASB has nearly completed its deliberations on measuring insurance contracts, and it is possible that the only remaining issues it will address prior to issuing an exposure draft are presentation, disclosure and transition issues.

REVIEW OF TENTATIVE DECISIONS UP TO FOURTH QUARTER

The decisions made during the fourth quarter of 2015 impacted or amended decisions made earlier, so it is worth reviewing those earlier decisions. Many of the earlier decisions impacted traditional insurance contracts reported under FAS 60 and limited payment contracts under FAS 97. Earlier tentative decisions were to update cash flow assumptions and discount rates used to value the reserves for these contracts. Cash flows would be based on "best estimate" assumptions updated once a year in fourth quarter. The impact of changes in cash flow assumptions would be reported by retrospectively unlocking the net premium ratio used in calculating the net premium reserve, similar to unlocking the k-ratio when calculating DAC for FAS 97 universal life-type contracts today. Thus, part of the change in the present value of future cash flows would be immediately reported in net income, but part would update the net premium ratio and be released into income over time. Discounting would be done at market interest rates consistent with high-quality fixed income instruments. Discount rates would also be updated once a year in fourth quarter. The impact of changes in discount rates would be reported in other comprehensive income (OCI). Net income would be reported using a discount rate locked in at inception of the contract. Because the net premium ratio would be capped at 100 percent, no separate premium deficiency or loss recognition test would be needed. And since current assumptions would be used, provisions for adverse deviations (PADs) would be eliminated.

DAC for all products (except investment contracts that use an effective yield calculation) would be simplified. DAC would be amortized over the expected life of the contracts in proportion to insurance in force. If the amount in force could not be reliably estimated (e.g., variable annuities), straight line amortization would be used. In either case, DAC would no longer accrete interest.

In addition, FASB tentatively decided to update the accounting for guarantees on variable contracts with more than insignificant capital market risk. Such guarantees would be reported at fair value, regardless of whether they are considered embedded derivatives or valued using SOP 03-1 under today's accounting. Affected guarantees may include variable annuity guaranteed minimum death, income, withdrawal and accumulation benefits, as well as variable universal life no-lapse guarantees. Although the change in fair value would be reported in net income, FASB deferred a decision on whether the impact of changes in non-performance risk (i.e., own credit) should be reported in net income or OCI.

FOURTH QUARTER TENTATIVE DECISION ON TIMING OF ASSUMPTION/DISCOUNT RATE CHANGES

One of the tentative decisions FASB made involved the timing of assumption and discount rate changes. FASB reversed its previous decision to require all such changes to be made in fourth quarter. Rather:

1. Cash flow assumption changes for FAS 60 and FAS 97 limited payment contracts would be made annually, in a consistent quarter each year, but a quarter of the company's choosing. In addition, a company could make an unscheduled update "if actual experience or other evidence indicates that earlier assumptions should be revised." This was meant to be similar to how assumptions are updated today for FAS 97 universal life-type contract DAC.
2. Discount rates would be updated quarterly for all contracts, including SOP 03-1 reserves on universal life-type contracts.
3. Fair value of variable annuity guarantees with more than insignificant capital market risk would be updated quarterly.

Some of these changes were in response to concerns expressed by actuaries, including in a comment letter sent by the American Academy of Actuaries' Financial Reporting Committee. Actuarial concerns included the fact that fourth quarter is often inconvenient for companies to update their GAAP assumptions, due to competing statutory requirements. Also, actuaries were concerned about possibly knowing of a pending event in first quarter, but being prohibited from reflecting that event for a substantial period of time. Another concern was that updating discount rates only in fourth quarter would cause accounting

mismatches between the liabilities and the fair value of the assets backing the liabilities, which are updated quarterly.

FOURTH QUARTER TENTATIVE DECISION ON TREATMENT OF NON-PERFORMANCE RISK ON VARIABLE CONTRACT GUARANTEES

In a separate tentative decision, FASB addressed the reporting of non-performance (or own credit) risk for variable contact guarantees which will be reported at fair value. FASB decided that the impact of changes in non-performance risk should be reported in other comprehensive income (OCI), rather than net income. So, for variable annuity GMxBs, for example, most of the change in fair value will be reported in net income, but the impact of changes in non-performance risk will be reported in OCI. This tentative decision should be beneficial from the standpoint of matching the accounting of GMxBs with the accounting for derivatives used to hedge the guarantees. Since hedging instruments are typically priced based at LIBOR rates, excluding the impact of changes in non-performance risk on the liability from net income should mitigate accounting mismatches in net income between the guarantees and the hedging instruments.

FOURTH QUARTER TENTATIVE DECISION ON PARTICIPATING CONTRACTS

The other tentative decision FASB made in fourth quarter was clarifying the approach for updating assumptions on participating contracts under FAS 120. The decision was consistent with the decision for non-participating contracts, but did not recognize some significant differences between participating and non-participating contracts. The decision confirmed that participating contracts should update cash flow assumptions annually, including mortality, expense, lapse and dividends, and discount rates, with part of the impact of the assumption change offset by retrospectively unlocking the net premium ratio. Discount rates should be updated quarterly with the impact reported in OCI. However, I see at least three problems with the decision:

1. Discount rates are based on high quality fixed income instruments, rather than the specific assets the insurer holds to back the liability. This is problematic for participating contracts because the dividend cash flows are determined based on the assets backing the liability. Under the FASB decision, if there are differences between movements in the "high-quality fixed income" reference rate and movements in the rates for the assets the insurer actually holds, there could be volatility in the insurer's financial statements, even though the economic risk from the interest rate changes is passed through to the policyholder. And at contract inception, if the "high-quality fixed income" reference rate is lower than the rate used in projecting dividend cash flows, a loss may result due to the 100 percent cap on the net premium ratio.

   There are a couple of ways I could see to remedy this. One would be to permit the discount rate to be consistent with the expected returns on the assets backing the dividend. Another would be to permit dividend cash flows to be projected assuming that the insurer earns the liability discount rate, rather than the insurer's best estimate of its own asset returns. This may add complexity, but would ensure consistency between the dividend cash flows and the liability discount rate.

2. Net income is based on a discount rate locked in at inception of the contract. Although the credited rate used to determine dividends on participating contracts varies with interest rates, the proposed accounting model locks in the discount rate used to determine net income. This means that if interest rates decline, projected future dividend cash flows would likely decrease as projected credited rates drop. But there would be no corresponding decrease in the discount rate used to determine net income (although the discount rate used for the balance sheet liability would be updated). And if interest rates rise, projected dividend cash flows would likely increase without a corresponding discount rate increase for net income purposes. As a result, insurers would show gains when interest rates decrease and losses when interest rates rise, even if there was no change in the insurer's economic position because the interest rate change would be passed on to policyholders.

   Some approaches to fix this could include treating discount rate and credited rate changes consistently when determining net income. This could mean projecting dividends for net income using a locked in credited rate, resulting in changes in credited rates being reflected in OCI, consistent with changes in discount rate. Or it could mean using a set of discount rates for determining net income that vary over time consistently with projected credited rates.

3. The impact to reserves of changes in projected cash flows related to credited rate changes is partially offset by retrospectively unlocking the net premium ratio. This is a problem because changes in the liability discount rate, which are driven by the same interest rate changes that would drive many credited rate changes, are not offset by retrospective unlocking. In order to reflect the full economic impact of interest rate changes, the full effect of both discount rate and credited rate changes need to immediately impact the liability.

> "Discount rates should be updated quarterly with the impact reported in OCI."

This issue is currently not a problem for net income because net income uses a locked in discount rate. But retrospectively unlocking for changes in credited rate could complicate efforts to fix issue #2 above. That is because if FASB wants to address issue #2 by using discount rates for net income consistent with the pattern of projected credited rates, the fact that the effect of changes in credited rates on projected cash flows is partially offset by retrospective unlocking would create a mismatch between the credited rate impact and the discount rate impact when determining net income. Conversely, if FASB wants to address issue #2 by locking in the projected credited rate, there would still be non-economic noise resulting from when the actual credited rate is "trued up," if the impact of the true up is partially offset by retrospectively unlocking the net premium ratio.

This issue could be addressed if the impact of credited rate changes on future cash flows is excluded from retrospective unlocking. This would add complexity, however.

SUMMARY

FASB has nearly completed deliberating targeted improvements to the measurement of long-duration insurance contracts. Some of their most recent tentative decisions were beneficial, in that they responded to actuarial concerns about the timing of updating assumptions and decided to exclude from net income the impact of changes in own credit on certain guarantees measured at fair value. But tentative decisions on participating contracts were more problematic, producing an accounting model that is out of sync with the characteristics of such contracts. ■

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