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FASB Update

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As of June 2016, the Financial Accounting Standards Board (FASB) has completed its deliberations on its proposed targeted improvements to long-duration insurance contracts accounting, and is in the process of writing an exposure draft of its tentative decisions. So with a brief lull on the GAAP insurance accounting front, it may be worth exploring some of the other recent FASB activities that may impact actuaries.

FINANCIAL INSTRUMENTS—RECOGNITION AND MEASUREMENT

As with insurance contracts, FASB had been working with the International Accounting Standards Board (IASB) to develop a converged accounting standard for financial instruments. And as with insurance contracts, the effort fell apart. IASB issued a comprehensive financial instrument accounting standard, IFRS 9, in 2014. IFRS 9 covered three areas of financial instrument accounting—classification and measurement, impairment, and hedging.

FASB has been working to issue new standards on each of these subjects separately. The first of these standards, ASU 2016-01, covers recognition and measurement and was issued in January 2016. The new standard takes effect for most companies in 2018. The new standard does not significantly change recognition or measurement for many of the financial instruments held by insurers.

On the asset side, debt securities will still be classified in one of three categories: trading, available-for-sale (AFS), and held-to-maturity (HTM). Trading securities will continue to be measured at fair value with all changes in fair value reported in net income (FV-NI). AFS securities will continue to be measured at fair value, but with certain changes in fair value reported in other comprehensive income (FV-OCI). And HTM securities, as well as originated loans, will continue to be measured at amortized cost.

Financial instrument liabilities will continue to be reported at amortized cost. Embedded derivatives will continue to be bifurcated from both asset and liability financial instruments and reported at FV-NI. And the fair value option will continue to be available for both financial instrument assets and financial instrument liabilities.

However, there are a few changes. For example, there are some new disclosures that will be required and some changes to deferred tax assets related to financial instruments. But probably the most interesting changes for actuaries relate to equity securities and to the fair value option.

Equity securities held as assets will no longer be eligible for FV-OCI or amortized cost measurement. Nearly all equity securities will be required to be accounted for at FV-NI. The only exceptions are for those measured using the equity method of accounting or that result in consolidation, but those situations would not likely apply to assets backing insurance contracts. There is also a practical expedient available for equities whose fair value is not readily determinable.

For financial liabilities that elect the fair value option, the impact of changes in own credit will no longer be reported in net income. Rather, the change in fair value resulting from changes in own credit will be reported in other comprehensive income. This alleviates situations where net income increases because the fair value of the liability decreased as a result of the insurer's creditworthiness becoming impaired, and vice-versa. Note that this treatment only applies to financial liabilities that elect the fair value option; for derivatives reported at fair value the impact of changes in fair value resulting from own credit changes will continue to be reported in net income.

FINANCIAL INSTRUMENTS—CREDIT LOSSES

In June 2016 FASB issued a new standard, ASU 2016-13, on credit losses or impairment. The new standard takes effect for SEC filers in 2020. This standard may impact actuaries who work with investments. There is also a bit of a stealth impact on some reinsurance valuations.

Under current US GAAP, values of financial assets are written down if there is an "other than temporary impairment." This write down is permanent and can never be reversed.

The new standard adjusts this approach for financial assets reported at FV-OCI. Since the fair value reported on the balance sheet already incorporates the market price of any impairment, an overhaul to credit loss recognition was not deemed necessary for FV-OCI assets. But there are some changes for determining the value to use for calculating net income. Rather than writing down the asset value, an allowance will be taken for any impairment against the asset value. This allowance can be reversed if circumstances change. Because the allowance can be reversed, the new standard requires recognizing a credit loss even for impairments judged to be temporary. The allowance is capped such

that the asset amortized cost value used for net income net of the allowance cannot be less than the fair value of the asset.

This cap may produce some asymmetry in reported results depending on interest rates. If interest rates have decreased since the asset was acquired, the asset fair value may have increased above amortized cost value, meaning the cap may limit the amount of any impairment recognized in income. This would not be the case if interest rates have declined. This also means that changes in interest rates could impact the amount of allowance recognized in net income, even if the expected credit loss has not changed.

For assets reported at amortized cost, the new standard introduces a completely new model for measuring credit losses, the "current expected credit loss" or CECL model. Under this model, an allowance is established against the asset value for the present value of all currently estimated expected credit losses over the contractual term of the asset. This means that some loss will be recognized on newly acquired amortized cost assets, except for assets whose expected credit losses are truly zero (such as, perhaps, U.S. Treasuries). For assets with a high credit standing this initial loss may be small, but the loss could be larger for lower credit-quality assets. There are special rules to avoid large losses for assets whose credit quality deteriorated prior to the asset being acquired.

The stealth issue for reinsurance actuaries is that the CECL model applies to reinsurance receivables. The new standard modifies paragraph 944-310-35-4 of Accounting Standards Codification (formerly paragraph 73 of FAS 113) so that a ceding company will be required to measure expected credit losses on reinsurance receivables under the CECL model. Expected losses related to disputed amounts will continue to be reported under existing GAAP. Although the impact of calculating a credit loss allowance for a reinsurance treaty with a highly rated reinsurer may be small, some work would still need to be performed. By a similar amendment, credit losses on premium receivables related to financial guarantee reinsurance will also be measured under the CECL model.

As with many recent FASB standards, the new credit loss standard also expands required disclosures.

FINANCIAL INSTRUMENTS—HEDGING

FASB is also working on revisions to the hedge accounting model, but these are not as far along as the recognition and measurement or credit loss portions of its financial instruments project. The intent is to simplify hedge accounting, and an exposure draft of the new proposals is expected later in 2016. However, at this point FASB does not seem inclined to address portfolio hedging, which will likely limit any benefits of the new model to hedged insurance risks, which are often hedged on a portfolio basis.

FAIR VALUE DISCLOSURES

In December 2015, FASB issued an exposure draft of a proposed standard to revise the disclosures associated with fair value calculations. As actuaries who value embedded derivatives are aware, these disclosures can be extensive and complex. The proposals in the exposure draft would clarify some language, remove certain disclosures and add others.

The American Academy of Actuaries Financial Reporting Committee submitted a comment to the exposure draft addressing a few aspects of the exposure draft. The comment letter viewed some of the clarifications positively, but expressed concerns about one aspect of the proposal to add disclosures. In particular, for "level 3" fair value estimates for which disclosures about assumptions are currently provided, the proposal would add a requirement to disclose the range and weighted average of each assumption. For lapse or mortality assumptions on a variable annuity guarantee, the range could be meaninglessly wide. Additionally, the weighted average can be extremely difficult to calculate, if the calculation has to be done over many scenarios, projected over many years, for each of many contracts. And the resulting weighted average may still not be very meaningful, and perhaps even misleading. After all, if one company's lapse assumption is lower than another company's assumption that could mean that one company is being more conservative. Or it could mean that the companies have different contract features that impact expected lapsation, or that they sell to different populations of customers. The weighted average itself would not reveal why one company's assumption differs from the other.

GOODWILL IMPAIRMENT

Under current US GAAP, goodwill is tested for impairment indirectly using a two-step test. The fair value of the reporting segment containing the goodwill is compared to the reported book value of the segment. If the fair value is higher, there is no impairment. If not, the second step must be performed. In the second step, the fair value of each asset and liability except for the goodwill must be calculated. If the net of these fair values of the individual assets and liabilities exceeds the fair value of the reporting segment, there is no impairment. Otherwise, the goodwill is impaired and written down such that the net fair value of the assets and liabilities plus the goodwill equals the fair value of the segment.

In May 2016, FASB issued an exposure draft of a proposal to simplify the goodwill impairment test. The proposal would eliminate the second step. This step can be time consuming and complex because a fair value calculation is needed for each asset and liability within the reporting segment.

However, there could be some negative consequences to eliminating the second step, especially for insurers. For example, in a rising interest rate environment the fair value of many assets reported on insurers' balance sheets may decrease, but the value of the insurance liabilities may not decrease accordingly. This mismatch may cause the reported book value of a reporting segment to drop below the fair value of the segment, so that the first step of the goodwill impairment test would fail. But the second step would calculate the fair value of the liabilities, so that if the liabilities were well matched to the assets, the liability fair value would be below the book value and the impairment may be avoided. If the second step is not performed, the goodwill may need to be written down even though there is no impairment in the segment from an economic standpoint.

A similar situation may occur because of hedging if the hedged risk is not measured at fair value, such as variable annuity guarantees measured under SOP 03-1, or a minimum interest guarantee on a universal life contract, which may not be explicitly measured at all. If the hedging instruments are reported at fair value and there is favorable experience, the reported value of the hedging instrument may decline more than that of the hedged item. This too could cause the book value of a segment to be less than the fair value, but the second step of the current goodwill impairment test would adjust for this.

So eliminating the second step of the goodwill impairment test could save a lot of effort, but it could result in situations where goodwill is written down just because of an accounting mismatch elsewhere on the balance sheet. Circling back to FASB's proposed targeted improvements for long-duration insurance contracts, some of the proposals could mitigate these situations. For example, some insurance liabilities would be discounted using a current discount rate, which would reduce the accounting mismatch with assets at fair value. And all variable annuity guarantees would be reported at fair value, reducing the mismatch with hedging instruments at fair value. However, not all insurance liabilities would use a current discount rate (for example, universal life contracts). And not all guarantees that may be hedged would be at fair value (for example, minimum interest guarantees and guarantees on many equity indexed contracts). So some of these accounting mismatches would persist, resulting in potential goodwill impairments if the second step of the goodwill impairment test is eliminated. ■

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