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FASB Long-Duration Contracts Redeliberations

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The Financial Accounting Standards Board (FASB) was busy in the second half of 2017 redeliberating decisions made under their long-duration contracts accounting project for insurance companies. FASB promulgates Generally Accepted Accounting Principles (GAAP) for general reporting purposes in the United States. FASB has been working on a project to update and improve accounting for insurance contracts for almost 10 years now. In 2015 it issued new guidance for short-duration contracts, requiring several additional disclosures. It is now approaching the finish line on its long-duration contracts project, and is expected to issue a new standard updating both disclosure and measurement of insurance contracts in 2018.

FASB had issued an exposure draft (ED) of its tentative decisions on long-duration contracts in September 2016. After receiving 39 formal comment letters responding to the ED, performing outreach with financial statement users and holding a roundtable discussion in April, FASB began redeliberating its ED proposals in August. Two more meetings followed in October and November. As a result of redeliberations, FASB made several key changes to its previous decisions. The basic scope of the proposed changes remains similar, however. As of December 2017, it appears that all major decisions have been made except for determining the effective date of the new standard, although no decisions are final until the standard is issued. The major changes that had been decided through December are discussed in this article.

TRADITIONAL NON-PARTICIPATING INSURANCE CONTRACT RESERVES

Under current US GAAP, traditional non-participating insurance contracts (FAS 60 and FAS 97 limited pay) hold net premium reserves based on assumptions that are locked in when the contract is issued unless a premium deficiency emerges. The assumptions, including the expected investment return that is used as the discount rate, include a provision for adverse deviation (PAD), which incorporates some conservatism into the reserve. A premium deficiency test is required periodically to ensure that the reported reserve is not inadequate.

Under the ED proposals, cash flow assumptions would be reviewed for possible updates at least annually. When assumptions are updated, the net premium ratio (and any deferred profit liability for limited pay contracts) would be updated retrospectively. That is, the net premium ratio would be reset assuming all actual historical experience, as well as the new assumptions, had been known since the contract was issued. This process is similar to current US GAAP accounting for deferred acquisition costs (DAC) on universal life contracts. The net premium ratio would be subject to a cap of 100 percent. One subtle change to the cash flow assumptions is that the ED eliminated most maintenance expenses from the reserve calculations, retaining only such non-level expenses as claim costs.

To the extent that the net premium ratio changes, that would offset part of the impact of the present value of future cash flows on the reserve. But the change in present value of future cash flows that would not be offset by unlocking the net premium ratio would impact the reserve immediately, with a corresponding impact to net income. Because the assumptions would be updated, provisions for adverse deviation were eliminated. And because the net premium ratio would be subject to a 100 percent cap, premium deficiency testing was eliminated.

In the ED, FASB proposed to treat the discount rate differently. FASB proposed using a more market-based objective discount rate than the expected investment (i.e., "book") yield, feeling that it was not appropriate for a non-participating liability value to be impacted by expected asset performance. FASB proposed discounting the liability using a "high-quality fixed-income yield," generally interpreted to mean a AA-quality bond yield. The discount rate would be updated each reporting period. The impact of changing the discount rate would be reported in other comprehensive income (OCI) without impacting the net premium ratio. Reporting the change in discount rates through OCI was deemed to avoid accounting mismatches with the assets insurers hold to back such liabilities, which typically report changes in fair value due to changes in interest rates through OCI.

Many companies and industry groups objected to the ED proposal to retrospectively unlock the net premium ratio. They felt that this would be costly to implement and would result in unnecessary net income volatility. Many comment letters proposed using a prospective unlocking approach instead, similar to the ED proposals for DAC. Many comment letters also objected to using a AA discount rate, feeling that such a rate was overly conservative and did not provide an adequate illiquidity premium.

In response, the board made a number of changes during redeliberations. The board felt that a retrospective unlocking approach provided the most relevant measure for a liability that represents a future cash flow. As a result, FASB retained retrospective unlocking for the net premium ratio. But it did make a number of changes to make the process somewhat less operationally burdensome.

FASB recognized that a significant portion of the cost of retrospective unlocking for universal life DAC relates to allocating items such as expenses and investment income to contracts. The proposed calculation of non-participating contract reserves would already not require an allocation of investment income and only a limited amount of expense would be permitted in the reserve calculation. So FASB decided to eliminate the requirement to unlock the remaining expense assumptions, leaving a company an option on whether or not to do so. FASB also recognized that much of the cost of retrospective unlocking relates to truing up actual experience, as opposed to just updating assumptions. So FASB decided to eliminate the requirement for companies to true-up actual experience each reporting period, permitting companies to choose to only true-up actual experience once a year at the same time as assumption updates. FASB also simplified the transition requirements for these contracts, as will be discussed in the "Transition" section of this article.

With respect to discount rates, FASB retained the requirement to update the discount rate each reporting period and report the impact of the change through OCI. But FASB agreed with the comment letters stating that a AA discount rate was overly conservative and decided to require an "upper-medium grade fixed income yield," generally interpreted as a single-A quality discount rate.

TRADITIONAL PARTICIPATING CONTRACT RESERVES

The ED proposed that participating contract (FAS 120) reserves (including those for closed blocks) be calculated in a manner similar to the proposed approach for non-participating reserves. Many comment letters objected on the basis that the proposed model was not suited to the unique features of participating contracts. For example, the proposed model would ignore the link between the investment returns on assets backing the liability and the dividend cash flows of the liability. In response to these comments FASB decided to exclude FAS 120 contract reserves from the scope of the targeted improvement project. Thus, FAS 120 reserves would continue to be calculated as they are currently, including the need for a premium deficiency test (without the inclusion of DAC). There would likely be some minor changes to accounting for these contracts to conform to other aspects of the targeted improvements, such as simplified DAC amortization. For example, currently terminal dividend liabilities are accrued over estimated gross margins (EGMs). With EGMs being eliminated from the DAC model, terminal dividend liabilities would likely be accrued using the new basis for amortizing DAC.

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UNIVERSAL LIFE CONTRACT RESERVES

The ED proposed significant changes to the calculation of SOP 03-1 reserves for additional death and annuitization benefits on universal life contracts. As with the participating contract reserve proposals, comment letters convinced FASB that the proposal would not work as intended. As a result, FASB decided to largely retain the existing approach to calculating SOP 03-1 reserves. There would likely be some minor conforming changes. For example, the discount rate to use for discounting payout annuity benefits back to the anticipated annuitization date would be the single-A "upper-medium grade fixed income yield," consistent with the discount rate for non-participating reserves.

Since the universal life contract valuation model would remain essentially unchanged, the premium deficiency test would continue to be required, albeit excluding DAC.

DAC AND SIMILAR ITEMS

Under current US GAAP there are multiple approaches to amortize DAC (and similar items such as deferred sales inducements and unearned revenue). Depending on which accounting model the underlying contracts fall into, DAC is amortized in proportion to premiums, estimated gross profits, estimated gross margins or in some cases in proportion to some other contract element, such as death benefits. Some DAC models use locked-in assumptions, others use retrospective unlocking. Some investment contracts use an effective yield approach to amortize DAC.

In the ED, FASB proposed to conform almost all DAC approaches, the exception being retaining the effective yield approach for certain investment contracts. FASB proposed to amortize DAC for all other contracts in proportion to amount of insurance, or if amount of insurance cannot be projected then on a straight line basis. Assumptions would be unlocked prospectively; that is, when future assumptions of terminations change, the future DAC amortization schedule would "pivot" to reflect the revised assumptions, but the current balance would not change. Interest would no longer be accrued on DAC or similar items. The amortization ratio would not be permitted to anticipate future renewal expenses or front-end fees. Rather, the

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amortization ratio would be updated as the new expenses were incurred, so the amortization ratio could increase over time even if experience materialized exactly as expected. DAC would no longer be tested for impairment.

In its redeliberations FASB retained most of their ED decisions. However, in response to comments that amount of insurance in force is not necessarily an appropriate amortization approach for all contract types, FASB agreed to be less restrictive. As a result, DAC and similar items would be amortized in constant proportion to some contract element (or straight line), but the contract element would not necessarily need to be the amount of insurance in force. DAC and similar items would still not accrue interest or be subject to impairment testing, and future renewal costs or front-end fees would still not be anticipated in the amortization ratio. Some actuaries remain concerned about the latter issue with respect to front-end loads in situations where the front-end fees are charged over an extended period, potentially resulting in an amortization ratio that increases significantly over time.

Some comment letters noted the irony that FASB was eliminating retrospective unlocking for DAC, partially in response to concerns from companies over cost and from users over incomprehensibility. On the other hand, FASB was introducing retrospective unlocking for non-traditional contract reserves. FASB seems to believe that a retrospective unlocking approach is appropriate for changes in future cash flows, and that the resulting volatility is meaningful as an improved measurement of the present value of future cash flows. However, FASB seemed to agree that retrospective unlocking of DAC, which represents a cash flow that has occurred in the past, is not particularly meaningful. In particular, FASB seemed concerned about the practice of amortizing DAC and then potentially reestablishing it through an unlocking event.

MARKET RISK BENEFITS

The ED introduced a new concept of a market risk benefit (MRB). This concept would apply to guarantees on certain variable contracts that expose the insurer to other than nominal capital market risk. In particular, guaranteed minimum death, income, withdrawal and accumulation benefits on qualifying variable contracts would be MRBs. Also, many variable life no-lapse guarantees would be MRBs. If a guarantee was considered an MRB, the benefit would be reported at fair value. Changes in fair value would be reported in net income, except for changes in fair value resulting from changes in own credit which would be reported in OCI. This accounting would apply regardless of whether the guarantee is considered an embedded derivative under current US GAAP.

In its redeliberations FASB expanded the scope of MRBs to go beyond just variable contracts. The revised scope seems to encompass guaranteed minimum death, income, withdrawal and accumulation benefits on both variable and indexed contracts. The equity indexing feature which is currently typically reported as an embedded derivative on EIA and EIUL contracts also appears to be within the revised MRB scope. However, FASB focused the revised scope on account balance guarantees, which may scope out variable life no-lapse guarantees. The revised basic definition of an MRB (excluding some explanatory language) as disclosed at the November 2017 FASB meeting is as follows:

"A market risk benefit shall be recognized for a contract feature that exposes the insurance entity to other-than-nominal capital market risk that arises from either of the following:

a. a contract feature that protects the account balance (or similar amount) from adverse capital market performance or

b. a contract feature that causes variability in the account balance (or similar amount) in response to capital market volatility."

It is not entirely clear which other insurance contract features would be scoped into this definition. It is possible that the definition may be refined and further clarified when the new accounting standard gets drafted in order to ensure that FASB scopes in the features it intends without scoping in other features.

DISCLOSURES

The ED proposed requiring many new footnote disclosures. In response to comment letter feedback FASB decided to eliminate a few of the more onerous requirements. But many new footnote disclosures would be added.

Most notably, roll-forwards would be required for all reserve and DAC balances. Information about assumptions and changes in assumptions would be required, as well as information about the impact of assumption changes on the reserve balances. For traditional non-participating contracts, information would be required about the gross premiums, net premiums and benefits, including their undiscounted amounts. For universal life contracts a table would be required showing guaranteed and current credited rates. For market risk benefits, information would be required about benefits whose fair value is an asset versus a liability. Disclosures would be required for non-participating traditional contracts whose net premium ratio gets capped at 100 percent and for other contracts that fail a premium deficiency test. And there would be other requirements as well. There may be some changes to the requirements as FASB gets feedback from users on their recent decisions, particularly on ED requirements that were eliminated.

TRANSITION

FASB made some minor and some major changes to the transition requirements from the ED. The most significant changes were to transition for non-participating reserves. Under the ED, non-participating reserves would have been required to use a retrospective transition. That is, the reserve would have had to be calculated since the contract was issued as if the new guidance had been in effect all along. Only if it was "impracticable" to determine or estimate the historical information necessary could a prospective transition be used. Under a prospective transition, the existing GAAP balance on the transition date would carry over (after removing any amounts that had been reported through OCI) and the net premium ratio would be calibrated to the reserve balance on the transition date. When assumptions would be updated in the future, the retrospective unlocking of the net premium ratio would go back to the transition date, not the original issue date.

FASB decided to change the ED proposal to instead require a prospective transition for all non-participating contract reserves. FASB is allowing an option to use a retrospective transition, but with several strings attached:

a. A company must be able to use actual historical data in order to apply retrospective transition; the historical information may not be estimated, and

b. a company must retrospectively transition all contracts issued in a given year or later.

For example, if a company had actual historical information for all contracts issued from 2014 and later, it would be permitted to use retrospective transition for all contracts issued in 2014 or later. It could choose a later issue date for which to apply retrospective transition, but not an earlier date. It could not retrospectively transition contracts issued in 2014 but prospectively transition contracts issued in 2016. Any contracts older than 2014 (or whatever year was chosen for retrospective transition) would have to be transitioned prospectively.

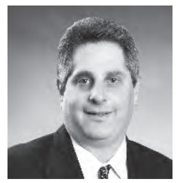
For DAC and similar balances the ED had proposed a prospective transition. FASB mostly retained this decision, but conformed the decision to the non-participating contracts decision. So, if a company decided to retrospectively transition all non-participating contracts issued in 2014 and later, it would also need to retrospectively transition all DAC for all contracts (including other types of contracts) issued in 2014 and later. If the company did not have the actual data to retrospectively transition all DAC on 2014 issues, it would also not be permitted to retrospectively transition non-participating contracts issued in 2014.

FASB also made a small but possibly significant change to the transition requirements for market risk benefits. The ED had required a retrospective transition. That is, the attributed fee associated with the market risk benefit would need to be calibrated to conditions as of the issue date of the contract. Many comment letters argued that this was an onerous requirement and also expressed concern that this could dramatically increase the reserve for these benefits upon transition, thus materially reducing GAAP equity. Comment letters also argued that it was unrealistic to require an actuary to estimate an attributed fee for a contract issued in, say 2006, and calibrate stochastic scenarios to do so pretending to be unaware of future dramatic events that had actually subsequently occurred, such as the significant stock market declines in 2008/2009 and negative interest rates.

FASB gave some relief to the latter issue by still requiring a retrospective transition, but permitting the actuary to use "hindsight" when calibrating the necessary scenarios. It is not entirely clear that this resolves all the practical issues, and this may not give much if any relief from the possible hit to GAAP equity upon transition.

CONCLUSION

Big changes are coming to GAAP accounting for long-duration contracts for insurance companies. FASB seems determined to conclude this project as quickly as possible, and so a final standard is expected in 2018, possibly in early 2018. Although we do not yet know when the new standard would be effective, we do know we would need to change our valuation models for several reserve categories. Valuation of non-participating traditional contract reserves is likely to become much more complicated. Many benefits on variable and indexed contracts that are not fair valued today would need to be fair valued in the future. DAC amortization would become simpler but there would still be one-time changes needed to the amortization models. And many more disclosures would be required. ■



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