Article from

The Financial Reporter

September 2018

Issue 114

FASB COMPLETES DELIBERATIONS ON TARGETED IMPROVEMENTS

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On June 6, 2018, the Financial Accounting Standards Board (FASB) held what they expect to be their last meeting on targeted improvements to US GAAP accounting for long-duration insurance contracts. This meeting was the culmination of a long process that took more than 10 years. For much of that time FASB was working with the International Account Standards Board (IASB) in an effort to achieve a converged international insurance accounting standard, but since 2014 FASB has been working on its own to effect targeted improvements to US GAAP accounting.

The most important result of the June 6 meeting was that FASB decided to proceed to issue a final accounting standards update (ASU) codifying the targeted improvements into US GAAP. The final standard is expected to be published during the third quarter of 2018.

Perhaps the most surprising result of the June 6 meeting was FASB's decision on the effective date. FASB decided that the **effective date will be Jan. 1, 2021,** for public companies whose fiscal year coincides with the calendar year, with early adoption permitted. This means less than two-and-a-half years between publishing the final standard and the effective date. Many insurers were hoping for, and expecting, a 2022 effective date, given the extensive and complex system updates that will be required. However, FASB board members believed that some of the decisions they made in 2017 to simplify transition and ease some of the burden of retrospectively unlocking assumptions obviated the need for that much implementation time.

INTEREST RATE AT TRANSITION

FASB did make one change at the June 6 meeting that will ease the transition burden somewhat. As already determined previously by FASB, companies will have the ability to apply either prospective or retrospective transition for DAC and traditional contract reserves (assuming the company had the data available for retrospective transition). Under a prospective transition, the initial DAC and reserve balance under the new accounting standard on the transition date would generally equal the DAC and reserve balance under current US GAAP on that date. There would be adjustments to back out shadow loss recognition and shadow DAC and any other amounts that had been reported through other comprehensive income (OCI). If the net premium ratio on the transition date was over 100 percent, the ratio would be capped at 100 percent with a resulting increase to reserves. The transition date would presumably be year-end 2018, assuming three years of historical information would be shown as of the Jan. 1, 2021, effective date.

Insurers had been concerned about the interest accretion rate that would be used to determine the initial net premium ratio and the ongoing split between net income and OCI under prospective transition. Under FASB's original approach, the interest accretion rate would be the rate on the transition date, i.e., year-end 2018. If this rate was significantly lower than the rate when the business was originally sold, this could cause the net premium ratio to reach the 100 percent cap, causing a reserve increase. Also, locking in an interest accretion rate at year-end 2018 for liabilities would cause a mismatch with the yield on assets which may have been purchased when the insurance contracts were sold, creating a mismatch in OCI.

A possible solution to this situation would have been to permit companies to use the single-A discount rate as of the date the contract was issued, even for contracts using prospective transition. This would also be the discount rate used for contracts using retrospective transition. FASB's solution was simpler. Under the solution FASB adopted, companies applying prospective transition would retain the locked-in discount rate used under current GAAP, i.e., FAS 60, as the locked-in interest accretion rate to determine the net premium ratio and net income/OCI splits. This should relieve pressure on insurance companies to try to apply the more complicated retrospective transition approach.

MARKET RISK BENEFIT DEFINITION

FASB made one other substantive change at the June 6 meeting. This was a further clarification of the definition of market risk benefits. Under FASB's targeted improvements, market risk benefits would be accounted for at fair value, with changes in fair value reported in net income, except for changes relating to changes in own credit, which would be reported in OCI. The definition of a market risk benefit has been refined a few times during the course of the project.

Under the latest definition, "a contract or contract feature that both provides protection to the contract holder from capital market risk and exposes the insurance entity to other-than-nominal

capital market risk should be recognized as a market risk benefit." The final standard should include additional paragraphs clarifying the meaning of the terms "protection" and "other-than-nominal capital market risk," and explicitly scoping out the death benefit component of life insurance contracts (but not of annuity or investment contracts). The intention is to define as market risk benefits most GMxBs (such as guaranteed minimum income, death, withdrawal and accumulation benefits) on variable, fixed and equity indexed annuities. These would be defined as market risk benefits whether or not they are considered embedded derivatives under current US GAAP. GMABs, GMWBs or similar living benefits on a variable life insurance contract may also be scoped into the market risk benefit definition. Other types of features, such as stable value features, may also be considered market risk benefits under the new definition. Certain other types of benefits that had been scoped in under previous definitions, such as variable life no-lapse guarantees and equity indexing features, would generally not be considered market risk benefits under the new definition.

SUMMARY

Assuming no unexpected issues arise, FASB has completed its deliberations on targeted improvements with these decisions. For a more complete discussion of previous decisions see "FASB Long-Duration Contracts Redeliberations" in the March 2018 edition of *Financial Reporter.* As a brief summary of the main changes:

- Traditional contracts: Assumptions and discount rates on traditional non-participating contracts, including limited payment contracts, would be updated. Net premium ratios would be subject to a 100 percent cap and updated retrospectively for changes in cash flow assumptions and for deviations between assumptions and actual experience. The discount rate would be a current upper-medium grade (low credit risk) fixed-income instrument yield (generally interpreted as single-A credit quality). Changes in discount rates would be reflected in OCI. Premium deficiency testing for these contracts and provisions for adverse deviations would be eliminated. There would be some refinements to the definition of maintenance expenses to be included in the reserve calculation.

- DAC: For all contracts except investment contracts using an effective yield approach, DAC (and related items such as unearned revenue liabilities) would be amortized on a constant level basis or straight line, accounting for expected terminations. DAC would be written down for actual terminations in excess of assumed. Changes to expected termination assumptions would be reflected prospectively. Interest accretion would be eliminated. Amortization ratios would exclude the effect of future expected deferred expenses that have not yet been incurred. DAC would not be subject to recoverability testing or premium deficiency testing.

- Market risk benefits: Contract features that both provide protection to the contract holder from capital market risk and expose the insurance entity to other-than-nominal capital market risk would be defined as market risk benefits. Variable life no-lapse guarantees would generally be scoped out of the definition. Market risk benefits would be accounted for at fair value, with changes in fair value reported in net income except for changes relating to changes in own credit, which would be reported in OCI.

- Other valuation changes: There would be some other conforming valuation changes, such as changes to how terminal dividend liabilities on participating contracts are accrued, and use of an upper-medium grade fixed-income instrument yield for discounting annuitization benefits reported under SOP 03-1

- Disclosures: Many new footnote disclosures would be required, including rollforwards of most reserve and DAC balances and increased supplemental information.

- Transition: For DAC and traditional non-participating reserves, companies could apply either prospective or retrospective transition, although if retrospective unlocking is elected it must be elected for all contracts in a given issue year and later. If prospective unlocking is elected, the discount rate for traditional non-par reserves would be the locked-in rate under current GAAP. For market risk benefits companies would be required to apply a retrospective transition, but the use of "hindsight" would be permitted.

Although this project is defined as "targeted improvements," the required changes are significant and will require substantial resources to implement. Based on FASB's June 6 decisions, we will have less than two-and-a-half years to get this done once the final standard is issued. It is imperative for actuaries and others involved in the financial reporting process to begin working on this as quickly as possible. ■

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