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Update on Changes to US GAAP for Long-Term Care Insurance

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Over the last several years, the convergence of U.S. generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS) has been the subject of a lot of discussion. The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) were engaged in a joint project to develop a common guidance that would address recognition, measurement, presentation and disclosure requirements for insurance contracts. However, the changes proposed by the FASB in the June 2013 exposure draft created many concerns, including:

- Slower premium and profit recognition, due to aligning premium recognition with the expected claim pattern. Long-term care insurance (LTCI) premiums are collected for many years with claim payments expected to occur later in the product's life. This change would have meant that premiums collected over the life of a LTCI contract would not be earned until closer to the end of the contract's expected life.
- U.S. insurers being at a disadvantage relative to their international peers because assumption changes would impact earnings immediately, while IFRS allowed changes to be recognized over time.
- The potential for earnings volatility, due to updating to a market discount rate each reporting period, which would not necessarily be tied to the actual portfolio of assets backing the liabilities.

After many years of deliberation and re-deliberation, in early 2014, the FASB voted to abandon the comprehensive changes to accounting for long-duration contracts, and instead focus on targeted improvements to existing US GAAP requirements. During the Aug. 31, 2016 board meeting, the FASB decided to issue proposed updates to the standards in late September or early October 2016. The Proposed Accounting Standards Update was exposed on Sept. 29, 2016 with the comment period ending on Dec. 15, 2016.

In this article, I will:

- Summarize the existing US GAAP requirements for long-duration contracts, impacting LTCI,
- Summarize some of the targeted improvements proposed to existing US GAAP requirements for long-duration contracts, impacting LTCI, and
- Discuss implications to LTCI of some of the targeted improvements proposed to existing US GAAP requirements for long-duration contracts.

CURRENT GAAP REQUIREMENTS

Currently, LTCI is governed by provisions for long-duration contracts under FASB ASC 944 (previously FAS 60), of US GAAP. The statement notes that "Premiums for long-duration contracts are recognized as revenue when due from policyholders. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders are accrued when premium revenue is recognized. Those estimates are based on assumptions—such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses—applicable at the time the insurance contracts are made. Claim costs are recognized when insured events occur. Cost that vary with and are primarily related to the acquisition of insurance contracts are capitalized and charged to expense in proportion to premium revenue recognized."

More simply, active life reserves (ALR) are held to provide for the liability associated with expected future claims on policyholders that are not in claims status as of the valuation date. On a GAAP basis, the ALR assumptions are established and locked in at issue, based on best estimate assumptions at that time with a provision for adverse deviation (PAD). Under FAS 60, a net level premium method is used for determining reserves. The net premium ratio is defined at issue as the present value of benefits (and in some cases, maintenance expenses), divided by the present value of gross premiums. The net premium for each subsequence period is then defined as the net premium ratio multiplied by the gross premium.

Amortization of the deferred acquisition cost (DAC) is determined in a similar way to the calculation of the reserves. The DAC amortization ratio, or k factor, is defined as the present value of the deferrable expenses, divided by the present value of the gross premiums. The amount of amortization each period is defined as the k factor multiplied by the gross premiums in that period.

The ALR and DAC are subject to annual adequacy testing, using current best estimate assumptions. This is called Loss Recognition Testing (LRT) under FAS 60.

Disabled life reserves (DLR) are held to provide for the liability associated with open claims on policyholders that are disabled as of the valuation date. DLR are calculated using best estimate assumptions as of the date of claim.

OVERVIEW OF PROPOSED TARGETED IMPROVEMENTS TO EXISTING US GAAP REQUIREMENTS FOR LONG-DURATION CONTRACTS

The proposed changes would converge the treatment of FAS 60 and FAS 97 products. This change would require annual updates of all cash flow assumptions used in calculating reserves, on a best estimate basis, at the same time each year, or more frequently if experience indicates that assumptions should be revised sooner. Additionally, the net premium ratio would be revised (subject to a cap of 100 percent) using actual historical experience since issue and updated future cash flow assumptions. A cumulative catch up adjustment would impact earnings in the current period. In subsequent periods, the revised net premium ratio is used to accrue the liability for future policy benefits.

Annual assumption updates eliminate the need for LRT and premium deficiency testing. Additionally, no PAD would need to be included in the assumptions.

The proposed discount rate would be updated on a quarterly basis, based on a portfolio of high quality, fixed income investments, not necessarily tied to the actual portfolio of assets backing the liabilities. The impact of changes due to the discount rate would flow through other comprehensive income, which is treated differently than the change in other reserve assumptions.

Under the proposed standards, DAC would be amortized over the expected life of a book of contracts in proportion to the amount of insurance in force. No interest would be accrued to the DAC balance.

IMPLICATION TO LTCI OF PROPOSED TARGETED IMPROVEMENTS TO EXISTING US GAAP REQUIREMENTS FOR LONG-DURATION CONTRACTS

On the "transition date," still to be determined, the proposed standards would apply to reserves retrospectively (with a cumulative catch-up adjustment to the opening balance of retained earnings). This could result in a significant change to ALR at the transition date and in the future, especially for LTCI carriers with large inforce books of business. For DAC, the guidance would be applied on the basis of the existing carry amounts on that date, adjusted for the removal of any related amounts in accumulated other comprehensive income, which means that although the amortization pattern of DAC could change in the future, a significant write down on the transition date may not be required.

Annual updates to the cash flows underlying LTCI reserves would better align reserve development with the most current view of future liabilities, and revising the net premium ratio would mitigate some of the associated volatility. However, the proposed basis for DAC amortization will be somewhat disconnected from the pattern of cash flows and profits.

Separately, the proposed change does address an issue facing LTCI carriers with significant old books of business, on which they have implemented premium rate increases. Under the current standards, insurers do not have a provision to set aside some of the additional premiums after an inforce premium rate increase in GAAP reserves. This is because the net premium ratio is locked at issue. A revised net premium ratio, reflecting actual experience and updated future cash flow projections, would allow for the recognition of rate increases in the GAAP reserves.

The potential for volatility due to updating the market discount rate each reporting period, which would not necessarily be tied to the actual portfolio of assets backing the liabilities, remains a concern with the proposed changes. With the prevailing low interest rate environment, this change has the potential to put additional upward pressure on reserve levels.

The proposed changes represent a significant paradigm shift for LTCI. In an industry already facing substantial of scrutiny from regulators, shareholders and policyholders, introducing more opportunities for volatility could be problematic. ■

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Proposed Accounting Standards Update, exposed Sept. 29, 2016: *http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168477111&acceptedDisclaimer=true*