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FASB Targeted Improvements Will Affect Long-Term Care

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The Financial Accounting Standards Board (FASB) is proposing significant changes ("Targeted Improvements") to the valuation and reporting of GAAP financial results for long-duration insurance contracts. This article only focuses on changes affecting traditional Long-Term Care (LTC) contracts and reflects the proposals as of late January. **All proposals are subject to change until FASB votes to issue an Accounting Standard Update** (ASU). The ASU is likely to be issued mid-2018. The effective date is not known as of this writing. Table 1 compares and contrasts the key elements of the proposal.

There are other changes, such as those affecting the measurement of "market risk benefits" related to guarantees on equity-indexed or separate account products.

NEW PROCESSES

If you are accustomed to developing and storing factors that are then applied seriatim to calculate reserves, you will need a new valuation system and new processes. Reserves will need to be calculated at least twice: once using at-issue discount rates and a second time using the same cash flows and net premiums but with current discount rates. When assumptions are updated, the impact will need to be identified in the new roll-forwards of present value of net premiums and present value of benefits.

A key change is the need to recalculate net premiums from issue (or transition date, if relevant) to reflect actual cash flows. This requires that historical cash flows be available to the valuation system, even for policies that are no longer in force. In general, this is easier to handle on a cohort basis. Net premiums are also recalculated when assumptions regarding future cash flows are updated, at the same time each year (unless facts and circumstances warrant an earlier update).

It is not clear from the standard whether the recalculation of net premiums to reflect actual cash flows should be done quarterly or should wait until assumptions are updated. When net premiums are recalculated, there is a beginning of period "catch up" adjustment to reserves. If the update process can be automated, quarterly financials will be more comparable if the net premiums can be recalculated each quarter.

COHORTS

Cohorts can be defined broadly or narrowly. Each approach has advantages. The proposed standard specifies that cohorts cannot include policies from different years of issue. Within year of issue, having a broad grouping reduces the number of cells that need to be managed but a narrower grouping, such as by product, may make it easier to explain results.

"A" QUALITY DISCOUNT RATE

GAAP valuation will no longer depend on the yields on investments in the company's portfolio. Instead, the valuation discount rate must reflect yields on upper-medium grade fixed-income instruments. In the U.S., this is interpreted as "A" quality bonds. A simple approach is to find an appropriate index that provides the average yield for "A" rated bonds. LTC has benefits payable at durations later than the maturity of any existing bond. You will need to decide whether and how to address this in the development of the valuation discount rate. Yield curves could be used or an equivalent level rate can be determined to ease storage and explanations.

In whatever way discount rates are developed, they need to be available quickly because the valuation can't be run without them. Two sets of rates and reserves are needed. The income statement will reflect reserves discounted using at-issue (locked-in) rates. Balance sheet equity will reflect reserves calculated using the same cash flows and same net premiums but discounted using current rates. The difference goes into accumulated other comprehensive income.

DAC AMORTIZATION

There are three changes to the amortization of acquisition expenses. There is no change as to which expenses are capitalizable. One change is that the unamortized DAC no longer accrues interest. Sums are used instead of present values. A second change is that a measure of in-force other than premiums is used as the amortization basis. For LTC, number of policies is a reasonable basis but measures such as maximum daily benefit may also be appropriate depending on the product design. The third change is that renewal deferable acquisition costs cannot be considered prior to their incurral.

The rule that reserves and DAC amortization must be based on the same assumptions remains in place. Unlike reserves, where the net premium is recalculated from issue when assumptions are updated, DAC amortization will be adjusted prospectively. The amortization rate will be adjusted to take into account the current unamortized DAC and the new projection assumptions.

Table 1
Comparison of Selected Targeted Improvements to Current Accounting

Current Accounting	Targeted Improvement
Locked-in assumptions	Insurance assumptions updated annually at the same time each year. Discount rates updated quarterly with difference from at-issue discount rates reflected in Accumulated Other Comprehensive Income (AOCI).
Insurance assumptions include Provision for Adverse Deviation (PAD)	No PAD.
Loss recognition and deferred acquisition cost recoverability required	No longer necessary. Net premiums are capped at 100 percent of gross premiums.
For traditional long-duration products, policy grouping is only relevant for loss recognition and DAC recoverability testing	Policies may be grouped but groups cannot contain contracts from different issue years.
Except when unlocking is required due to loss recognition, the net premium for each policy is locked-in at issue	Net premiums are updated to reflect the substitution of actual for expected experience and for updates to insurance assumptions. This results in "catch-up" adjustments to reserves. Net premiums are not affected by after-issue changes in discount rates.
Discount rate is best estimate less PAD	Discount using upper-medium grade fixed-income instrument yield ("A" quality in U.S.) that maximizes the use of market observable inputs.
Increases in reserves are reported in "Change in provision for future policyholder benefits" in the income statement	The catch-up adjustment is reported separately from increase in reserve, such as in the Benefits line. Impacts of changes in discount rates after the year of issue affect Other Comprehensive Income.
Deferred Acquisition Costs (DAC) are amortized in proportion to premiums. Unamortized DAC accretes interest.	No interest accretion. DAC is amortized on a straight-line basis reflecting changes in in-force.
DAC amortization net premium considers future deferrals (and is locked-in at issue)	DAC amortization rate cannot anticipate future deferrals. Consequently, the amortization rate increases when there are additional deferrals.
Limited disclosures	Disclose roll-forwards for: DAC, present value of reserve net premiums and present value of benefits. Disclose information about significant assumptions.

EXPERIENCE ASSUMPTIONS

Valuation assumptions will no longer include provisions for adverse deviation (PAD) and will need to be updated annually, at the same time each year. Discuss with your accountants the extent to which this needs to be coordinated across product lines and reporting entities. In the event of an unusual circumstance, if an earlier update would be appropriate it would, in fact, be required. "Updated annually" does not mean that every assumption needs to be changed annually, but an annual review process will be needed.

When assumptions are updated for pricing, besides the obvious impact on new business valuation, the effect on in-force valuation assumptions should be evaluated.

THE PLANNING PROCESS WILL BE MORE COMPLEX

If your company's business plan cash flows are not already related to best estimate assumptions, you should consider making the linkage because of the requirement that reserve net premiums be recalculated to reflect actual cash flows. When PADs are eliminated, the projected cash flows used to calculate reserves can also be used for business planning, with future new business then layered on. Future deferrals of acquisition expenses (new and renewal) must also be layered on. The challenge comes if aggregate premiums or benefits are adjusted in the plan for any reason because those adjustments should be recycled into the reserve calculation. Premium adjustments could imply a change to in-force that will affect future cash flow projections. Differences between

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Plan benefits and those expected by the reserve valuation should result in new net premiums (unless already capped at 100 percent of gross premiums) and a catch-up adjustment to reserves, which will offset a portion of the change in benefits. Theoretically, the adjustments need to be allocated to years of issue. For a multi-year plan, this allocation is needed because it affects the net premium for each year of issue and the growth in future years' reserves.

TRANSITION

The default approach to transition is to start with currently reported balances as of the beginning of the earliest period presented and apply the Targeted Improvements prospectively. For example, suppose the guidance is effective for fiscal years beginning after Dec. 15, 2020. Further suppose that LTC Company uses calendar year reporting and it presents two prior comparative years. In this case, the first quarterly report in 2021 would compare to 2020 and 2019. Under the default approach, 12/31/2018 reserves and DAC would be used as the 1/1/2019 opening balances. If the reserve net premiums for any cohort would be negative or greater than 100 percent of gross premiums, then that cohort's 1/1/2019 reserve balances would be restated to equal the present value of benefits (discounted at "A" bonds yields) less the present value of capped or floored net premiums. Any differences between the old and new balance sheets will be taken as a cumulative adjustment to equity for a change in accounting principle.

Under the optional transition approach, LTC Company can use an earlier transition year provided it has actual data for the intervening years. No estimates are allowed. The transition year is an "accounting election" so check with your accountants for the extent to which all lines of business (including possibly in other legal entities) must make the same election. The opening reserve balances, by cohort, would be based on the reported transition date reserves, actual claims from there to the earliest period presented and "future" cash flows. Continuing the example, suppose LTC Company chose 1/1/2015 as its transition date. The net premium for the restated Q1 2019 income statement would reflect actuals for 2015–2018 and projections thereafter using 2018 best estimate assumptions, as shown in Formula 1.

Present values are calculated using "A" bond yields from the later of the policy cohort's issue period and the transition date (1/1/2015 in our example), according to board decisions through January 2018. These net premiums would be capped at 100 percent of gross premium and floored at zero. Two reserves would then be calculated as of 1/1/2019. Both would be PV(Benefits) – PV(Net Premiums) but the opening reserve for the income statement would use the same discount rates as were used to calculate the net premium while the reserve for the balance sheet would use "A" bond yields at 12/31/2018.

DAC must use the same transition date as reserves and the persistency assumptions for projecting future in-force or number of policies must be consistent with those used for projecting benefits and premiums. In our example, the initial DAC amortization rates by cohort would be calculated using the reported 12/31/2014 DAC balances and projected policy counts or in-force amounts using then-current best estimate assumptions. The amortization rates would be updated in successive periods to reflect additional acquisition costs incurred during the period and for assumption unlocking each year. Even though DAC amortization has been "simplified," it will be more work to roll it forward from the transition date to the first date presented. Any difference between this new DAC and the old DAC on the first date presented will be taken as a cumulative adjustment to equity for a change in accounting principle.

NEW EARNINGS PATTERNS

The effects on earnings emergence deserves its own article. There is no more "release from risk." Whether there's a gain from interest on reserves will depend on how the portfolio's new money rate compares to "A" bonds. Overall, due to the removal of PADs from other assumptions, it's likely that a smaller portion of premiums will be required for reserves. This will increase early duration earnings, but may be more than offset by faster early amortization of DAC due to the lack of interest accretion. The effect on the entire block after transition will depend on your mix of business, whether the block

Formula 1

$$\text{Net Prem \%}_{\,1/1/2019} = \frac{\text{12/31/2014 Res + PV(Actual benefits 2015–2018 and Projected future benefits)}}{\text{PV(Actual gross premiums 2015–2018 and Projected future gross premiums)}}$$

Table 2

Roll-Forward of Reserves		Dec. 31 20x2	Dec. 31 20x1
Present Value of Expected Future Policy Benefits	Balance, beginning of year	4,220	4,150
	Beginning balance at original discount rates	4,160	4,090
	Change in cash flow assumptions	10	40
	Effect of variances from cash flow assumptions	(20)	80
	Adjusted beginning of year balance	4,150	4,210
	Issuances	260	245
	Interest accrual	205	210
	Benefit payments	(650)	(510)
	Experience adjustments	(5)	5
	Ending balance at original discount rates	3,960	4,160
	Effect of current discount rate assumption	50	60
	Balance, end of year	4,010	4,220
Present Value of Expected Net Premiums	Balance, beginning of year	2,740	2,900
	Beginning balance at original discount rates	2,715	2,830
	Change in cash flow assumptions	5	30
	Effect of variances from cash flow assumptions	(15)	65
	Adjusted beginning of year balance	2,705	2,925
	Issuances	240	225
	Interest accrual	105	120
	Less Premiums received	(590)	(560)
	Experience adjustments	(5)	5
	Ending balance at original discount rates	2,455	2,715
	Effect of current discount rate assumption	20	25
	Balance, end of year	2,470	2,740
	Net liability for future policy benefits	1,540	1,480
	Reinsurance recoverable	0	0
	Net liability after reinsurance	1,540	1,480

Undiscounted Values	Dec. 31 20x2	Dec. 31 20x1
Expected future gross premiums	4,370	4,900
Expected net premiums	2,670	2,990
Expected future benefit payments	4,580	4,915

Roll-Forward of DAC	Dec. 31 20x2	Dec. 31 20x1
Opening DAC	900	860
Capitalization	100	100
Amortization	(70)	(60)
Ending balance	930	900

has been through loss recognition, and how the discount rates that get locked in compare to the current portfolio yield.

NEW DISCLOSURES

There are several new disclosures. Roll-forwards of unamortized DAC and reserves are required for both annual and interim statements. The normal rules apply with regard to aggregation/disaggregation of product lines and comparisons to prior period(s).

Additional disclosures include the weighted average duration of the liability and the weighted average discount rate.

For annual reports, for DAC and for reserves, disclose information about the significant inputs, judgments, assumptions, and methods used; changes in those significant inputs, judgments, assumptions and methods; and the effect of those changes on the measurement of DAC and reserves.■

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