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FAIR VALUE FOR VARIABLE ANNUITY GUARANTEES

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The Financial Accounting Standards Board (FASB) met in September to discuss targeted improvements for accounting for long-duration insurance contracts under US GAAP. At the meeting they made some key tentative decisions regarding guarantees on certain non-traditional contracts. They also began discussing certain aspects of accounting for participating traditional contracts.

FASB tentatively decided that certain guarantees on certain non-traditional insurance contracts should be reported at fair value. According to the discussion papers for the meeting, the affected contracts would be non-traditional contracts which "allow the policyholder to direct all or a portion of his or her account balance into an investment that passes the risks and rewards of holding that investment to the policyholder." Clearly that includes variable or unit-linked contracts. It is not entirely clear whether other contracts, such as equity indexed contracts, would be impacted. Guarantees within such contracts that would be impacted would be those which have "other-than-nominal capital market risk." Guarantees would be presumed to have other-than-nominal capital market risk if "the benefit varies significantly in response to capital market volatility."

It remains to be seen exactly how the criteria will be worded in a formal document, but it was clear from the discussion that minimum interest guarantees would not be considered to have other-than-nominal capital market risk. However, many variable annuity guarantees would be covered, including guaranteed minimum death benefits (GMDB) and guaranteed minimum income benefits (GMIB), currently accounted for under SOP 03-1. Guaranteed minimum withdrawal benefits (GMWB), including lifetime withdrawal guarantees, and guaranteed minimum accumulation benefits (GMAB) would also be covered, although these are often accounted for at fair value today as embedded derivatives. The decision also appears to cover other guarantees, such as no-lapse guarantees on certain variable universal life contracts.

The change in fair value for the affected guarantees would generally be reported in net income. However, FASB deferred a decision on whether the impact of changes in non-performance risk (or own credit risk) should be reported in net income or in other comprehensive income (OCI). If they decide to report the impact of changes in non-performance risk in OCI, this would apply equally to guarantees covered by this decision that are considered embedded derivatives under current GAAP. So even though such guarantees would continue to be reported at fair value, there could be a change to the income statement presentation if FASB ultimately decides to use OCI for changes in non-performance risk.

Fair value for the covered guarantees may be more volatile than existing accounting treatment, such as SOP 03-1. But there are a number of benefits to this decision. Various forms of variable annuity guarantees will be treated consistently, regardless of technicalities around whether they meet specific embedded derivative criteria. FASB also noted that certain guarantees, such as lifetime withdrawal benefits, are accounted for differently by different companies, so this decision would provide consistency. Also, this decision is likely to facilitate hedging of guarantees currently accounted for under SOP 03-1. Hedging instruments are generally reported at fair value, with changes in fair value reported in net income, which is not consistent with SOP 03-1. So under existing GAAP, hedged guarantees often create accounting volatility, even though economic risk is reduced, due to this mismatch in accounting treatment. So this decision would alleviate that issue. ■

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