Article from
Product Matters!
October 2019
Issue 114

FASB Long Duration Targeted Improvements Impact on VA and FIA Product Development and In-Force Management

By Kenneth Birk and Yuan Tao

In August 2018, the Financial Accounting Standards Board (FASB) introduced a new guidance, Accounting Standards Update (ASU) 2018-12, titled "Targeted Improvements to the Accounting for Long Duration Contracts" and commonly referred to as long duration targeted improvements (LDTI). The new guidance amends four key areas of accounting and disclosures for long duration insurance contracts and is the most significant GAAP accounting change impacting the life insurance industry in the past 40 years. At the time of this writing, these changes are expected to be effective Jan. 1, 2022, for Securities and Exchange Commission filers and Jan. 1, 2024, for other entities.[1]

This article discusses the impact of LDTI on variable annuities (VA) and fixed indexed annuities (FIA) from a product development and in-force management angle.

BACKGROUND ON LDTI ACCOUNTING CHANGES

Despite the name "targeted improvements," the new guidance brings significant changes to the accounting for long duration contracts in four main areas. These are summarized in Table 1.

As indicated in the table, the changes for market risk benefits (MRBs), deferred acquisition costs (DAC) and disclosure will all impact VA and FIA contracts. MRB changes will have the most impact on VA and FIA. Under the new standards, all guaranteed minimum living and death benefits (commonly referred to as GMxBs) on VA and FIA contracts will be classified as MRBs and are required to be measured at fair value. The change in fair value will flow through income, with the exception of instrument-specific risk, which will be recognized in other comprehensive income. This is a significant change from the current two-measurement accounting framework in which some riders are accounted for using fair value while others are not.

Table 1
FASB Long Duration Targeted Improvements Accounting Changes at a Glance

Area of Change	Current GAAP	LDTI Change	Impacted Products*
Liability for future policy benefits	- Original assumptions with provisions for adverse deviations (PAD) locked in at issue - Discount rate is the insurer's earned rate with PAD locked in at issue	- Best-estimate assumptions without PAD - Assumptions reviewed and potentially updated at least annually - Discount rate is upper-medium grade, fixed-income instrument yield (commonly referred to as "single A")	Non-par term and whole life, long-term care/disability, immediate/payout annuities
Market risk benefits	Two measurement models (fair value and insurance)	One measurement model at fair value, improving uniformity	GMxBs on VA/FIA
Deferred acquisition costs	- Complex amortization - Method varies by product	Simplified amortization ("straight-line"), same for all products, increasing understandability	All long duration contracts
Disclosures	Limited disclosures	Enhanced disclosures	All long duration contracts

*Additional products or product features may apply.

Impact on Hedging and ALM

We believe many VA and FIA writers will re-evaluate their hedging and asset liability management (ALM) strategy following the move to fair value accounting for all VA and FIA riders under the new MRB requirement.

Variable Annuities

Hedging has been an important aspect of in-force and risk management for almost all VA writers. Industry practices varied by product, and carriers have historically targeted fair value, GAAP profits and losses (P&L), statutory capital or a hybrid. Hedging has been considerably impacted by mismatches under existing accounting frameworks.

A conceptual illustration of the market sensitivity of fair value, GAAP and statutory framework before and after LDTI and the National Association of Insurance Commissioners' (NAIC) VA statutory reform is shown in Figure 1.

Under the current U.S. GAAP framework, only some of the VA riders are reported using fair value (typically guaranteed minimum accumulation benefit, guaranteed minimum or lifetime withdrawal benefit) while others are not (guaranteed minimum death benefit and guaranteed minimum income benefit). Under current statutory framework (Actuarial Guideline 43 [AG 43] and C3 phase 2), VA reserve and capital are sensitive to equity but largely insensitive to interest rates and volatility. This mismatch between accounting frameworks makes it difficult for insurers to hedge all valuation lenses effectively.

Under LDTI, all GMxBs will be accounted at fair value, thus bringing uniformity for GAAP accounting. Concurrently, on the statutory side, the NAIC has adopted VA statutory reform that will increase liability market sensitivity (expected to be effective in 2020 at the time of this writing).

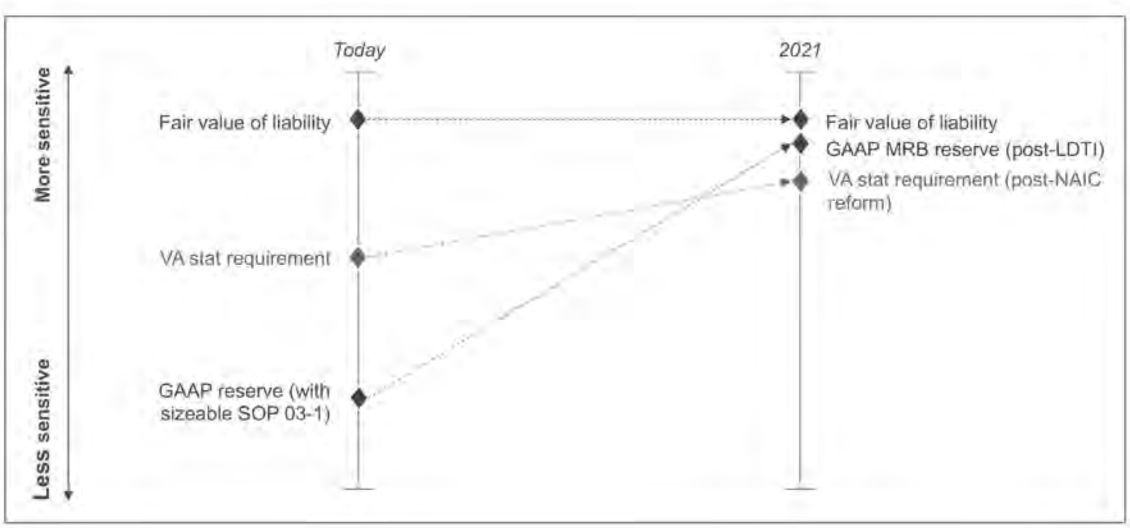
Thus, post reforms, both GAAP and statutory liabilities will be more reactive to markets, and as a result, we expect that many VA writers will increase their hedging coverage. This would in turn impact realized hedge P&L cash flows and VA in-force and new business economics. This effect will be considered as part of merger and acquisition transactions for in-force blocks and as part of product and pricing for new business.

Fixed Indexed Annuities

Historically FIA writers have hedged the indexed account balance accumulation but have often excluded the GLWB riders because current GAAP accounting is not fair value and lacks market sensitivity. Meanwhile, the AG 33/AG 35 statutory reserves for FIA at the total contract level are also largely insensitive to market movements.

The most frequent practice in the FIA space is to hedge the base contract liability (account value) for the market upside and to selectively reduce the amount of base contract hedging considering guarantees provided by the GLWB (primarily to handle statutory capital volatility). Meanwhile, interest rate risk is handled for the base contract and GLWB in combination, using

Figure 1
Market Sensitivity of Liability Valuation Across Valuation Frameworks—VA GMxB



Abbreviations: GAAP, generally accepted accounting principles; LDTI, long duration targeted improvements; MRB, market risk benefits; NAIC, National Association of Insurance Commissioners; VA, variable annuities.

traditional ALM principles, since most assets backing FIAs with GLWB are held in general account fixed-income assets.

Under LDTI, FIA GLWB riders will be classified as MRB with increased market sensitivity, particularly to interest rates. This and the integration with traditional ALM and management of statutory capital will cause challenges, as statutory changes on FIA GLWB are still relatively distant and will likely not be retroactive.

As of current, we believe that most FIA writers will define non-GAAP adjusted operating earnings in a way that removes the discount rate impact and seek to largely maintain their current hedging practices. Still, questions are likely to arise on the volatility of unadjusted GAAP results. That is, equity analysts will seek to understand whether the volatility is caused by an inherent asset-liability mismatch or is the result of "non-economic" basis risk between assets and liabilities.

Impact on Product Strategy and Development

LDTI will cause VA and FIA writers to reassess their product strategy and development process.

- **Product mix.** Companies will need to consider their appetite for product lines and businesses that create accounting exposure to systematic market risk. As part of this, they will need to evaluate shareholder and stakeholder tolerance for market risk and potential impact of additional hedging on product economics.

- **Product design.** The extent of guaranteed benefits will need to be evaluated and tuned to produce an acceptable risk/return profile, from both an economics and an accounting perspective.

- **Education on new risks.** Key drivers of MRB reserve movements will be interest rate and account value. Regardless of product changes, there will be a need to educate management and risk stakeholders on the new risks and obtain their input in the product development process.

Impact on Pricing

LDTI will undoubtedly impact how VA and FIA are priced. Here are some of the key pricing considerations:

- **Profit targets.** VA and FIA carriers will need to reconsider their pricing targets and contemplate any potential downside targets if not done already. Risk tolerances or limits for these products should be evaluated under LDTI.

- **Pricing models.** Any necessary modifications to the current pricing models will need to be determined. If pricing on a GAAP basis, the pricing model should reflect the accounting changes, including MRB liabilities, simplified DAC amortization and any potential associated assumption and hedging change. Modeling simplifications may be considered as practical expedient, but the impact of simplifications will need to be assessed and communicated.

- **Scenarios.** Risk-neutral scenarios are required to calculate fair value of MRBs for more products and features than in the past. Generating risk-neutral scenarios requires the appropriate scenario generator, modeling platform and market inputs. Scenario generation for FIA MRBs is inherently more complicated than for VA. Considerations should also be given to the adequate number of scenarios and any simplification techniques to balance speed and accuracy.

- **Assumptions.** Companies will need to consider whether they need to develop new assumption sets for MRBs. In particular, for contracts containing multiple features that are MRBs (such as GMDB and GMWB), those MRBs are required to be bundled as a single compound MRB, which means their assumptions need to be consistent and integrated.

- **Hedging.** Cost of hedging affects product economics and should be accounted for in pricing. If there is a change in hedging strategy as a result of LDTI that could potentially increase the cost of hedging, this should be evaluated in pricing.

All considered, it is likely that the pricing and design of VA GMDB, VA GMIB and FIA GLWB—which previously were not at fair value—will be most impacted by the changes inherent in LDTI. The extent of the changes will depend on whether cash-flow economics deteriorate as a result of changes to hedging strategies.

CONCLUSION

LDTI will have a profound impact on the insurance industry. While most carriers are focused on methodology and implementation, there are meaningful impacts to consider for VA and FIA product development and in-force management:

- **Hedging and ALM impacts.** Any change in hedging and ALM strategy to mitigate accounting volatility will have economic impacts to reflect in product strategy and pricing.

- **Product design and strategy.** Stakeholder appetite for accounting volatility and resulting changes to hedging and ALM may trigger changes in product mix and designs.

- **Pricing.** In addition to updating pricing infrastructure to handle the new requirements, pricing actuaries will need to produce analyses to educate stakeholders on the risks and pricing implications of any changes to designs, hedging and ALM. ■

The views expressed in this article are those of the authors and do not necessarily reflect the views of the authors' firms.

Kenneth Birk, FSA, CERA, MAAA, is a vice president and actuary at Global Atlantic. He can be reached at *kenneth.birk@gafg.com.*

Yuan Tao, FSA, MAAA, CFA, is a senior consultant at Oliver Wyman. She can be reached at *yuan.tao@oliverwyman.com.*

ENDNOTE

1 Does not include smaller reporting companies (SRC), generally defined by the SEC on the basis of public float (less than $250 million) or annual revenue (less than $100 million).