

Impact of FASB Targeted Improvements on VA/FIA Product Development

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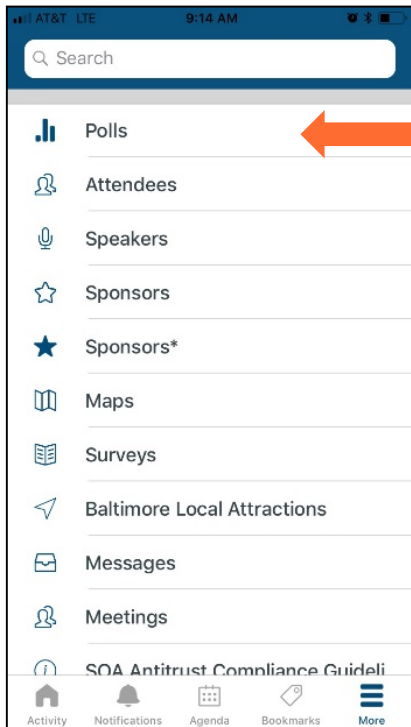
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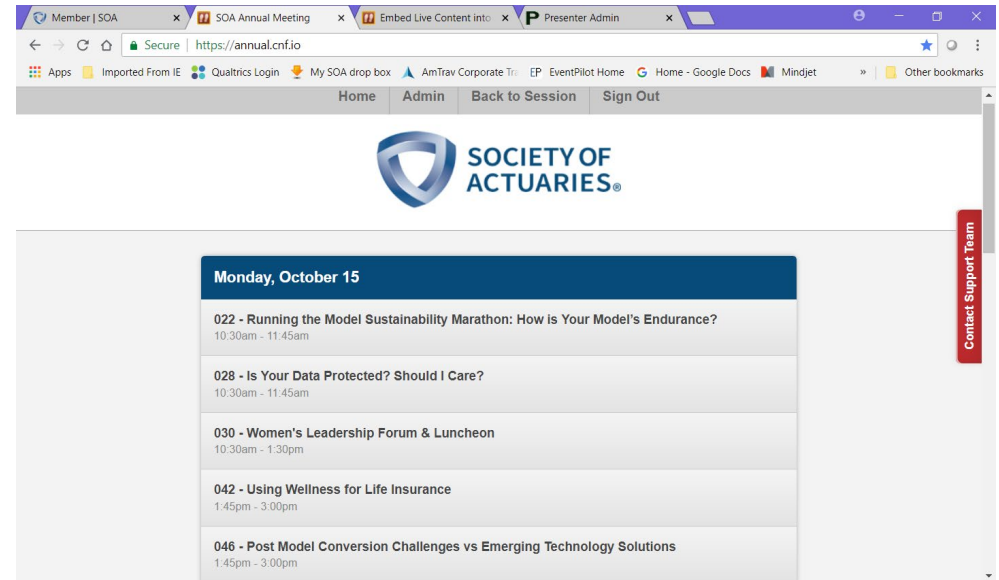
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**Poll: How would you best describe your
role in your organization?**

Agenda

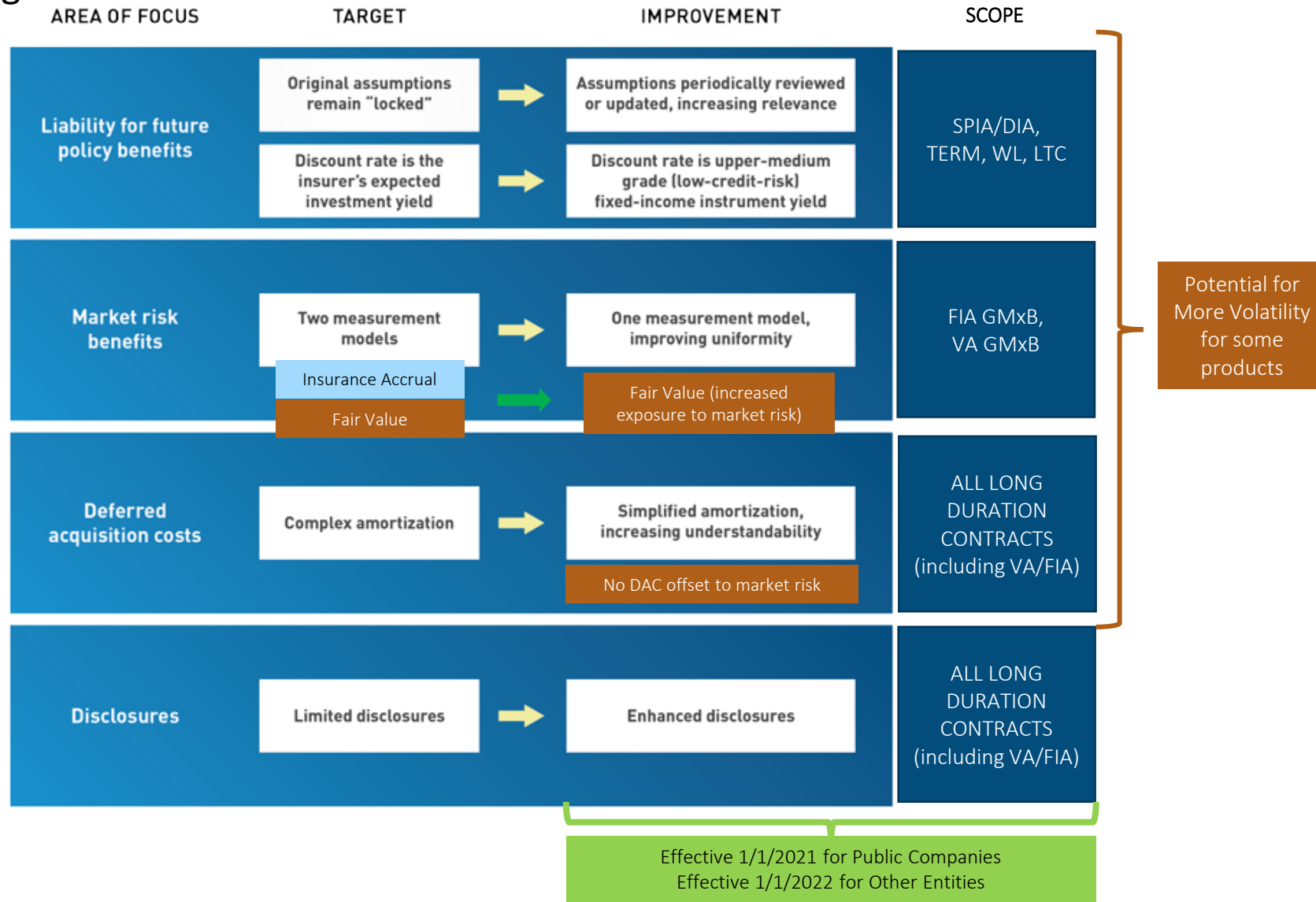
- FASB Long Duration Targeted Improvement Changes & Implications
- Market Risk Benefit (MRB) Definition, Scope & Measurement
- VA/FIA Pricing & Product Development Considerations

FASB Long Duration Targeted Improvement Changes & Implications



FASB 'Long Duration Targeted Improvements' Accounting Update

What Will Change?



Source: FASB

General Annuity Summary of Accounting Impacts

For VA GMDB/GMIB & FIA GMxB, the key issue is potentially lower earnings, with more balance sheet and earnings volatility.

Area	Opening Equity	Profit Emergence	Earnings Volatility	OCI/Equity Volatility
FIA without GMxB	<p>Increase</p> <p>Due to <i>removal of DAC shadow adjustment</i></p>	<p>Decelerated</p> <p>DAC <i>no longer accretes with interest</i></p>	<p>Slightly decreased</p> <p>DAC <i>no longer subject to retrospective unlocking and volatility of assumption updates</i></p>	<p>Increase</p> <p>Shadow DAC <i>no longer offsets movement in associated AFS assets</i></p>
VA & FIA with Guaranteed Minimum Benefits (GMxBs)	<p>Decrease</p> <p>Current SOP 03-1 treatment will move to fair value, <i>increasing the liability</i></p>	<p>Slower</p> <p>Fair value approach will <i>build-up liabilities earlier</i> than the SOP 03-1 approach</p>	<p>Increase</p> <p>Fair value liabilities tend to be <i>more volatile</i> than SOP 03-1 calculations</p>	<p>Increase</p> <p>Fair value liabilities tend to be <i>more volatile</i> than SOP 03-1 calculations</p>

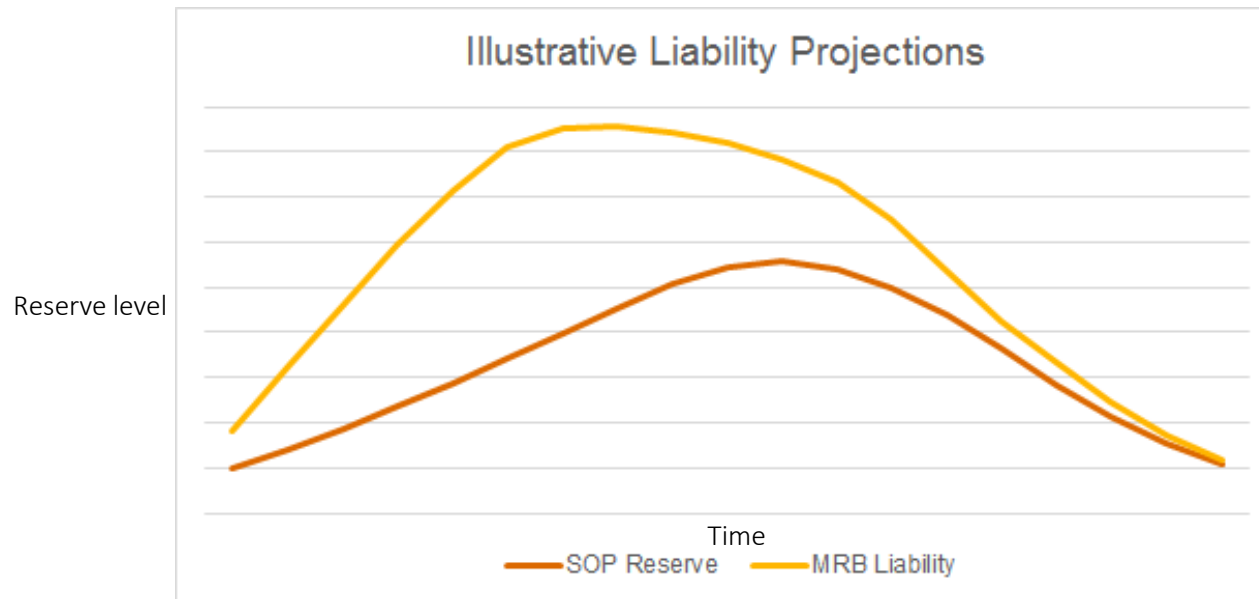
Change	FIA with GMxB; VA with GMDB/GMIB
Current	<p>Lower, Stable liability</p> <ul style="list-style-type: none"> - Discount Rates NOT marked-to-market (liability crediting rate) - AV growth includes risk premiums such as equity & credit
Future	<p>Increased, Volatile liability</p> <ul style="list-style-type: none"> - Discount Rates marked-to-market (risk free rate) - AV growth based on forward swaps

Source: PwC

Summary of GMxB Changes

- GMxB treatment under SOP 03-1 & FAS 157 is being replaced with a new concept called Market Risk Benefits
- Lifetime profits will be the same, but the emergence of profits will be slower and more volatile

GMxB	Current GAAP	New GAAP
VA GMWB/GLWB	<ul style="list-style-type: none"> • Typically FAS 157 for non-lifetime GMWBs • Diversity in practice exists for lifetime GMWBs <ul style="list-style-type: none"> • Full FAS 157 • Hybrid FAS 157/SOP 03-1 	Market Risk Benefit (MRB) <ul style="list-style-type: none"> • To be measured at Fair Value • Changes in fair value flow through P/L, except changes in instrument specific credit risk recognized in Other Comprehensive Income • If a contract contains multiple MRB, those MRBs shall be bundled together as a single compound market risk benefit
VA GMAB	FAS 157	
VA GMIB	<ul style="list-style-type: none"> • Typically SOP 03-1 • FAS 157 if benefit is not settled 	
VA GMDB	SOP 03-1 <ul style="list-style-type: none"> • Payment is a result of an identifiable insurable event 	
FIA GMxB	Typically SOP 03-1	



Source: PwC

MRB Definition, Scope & Measurement



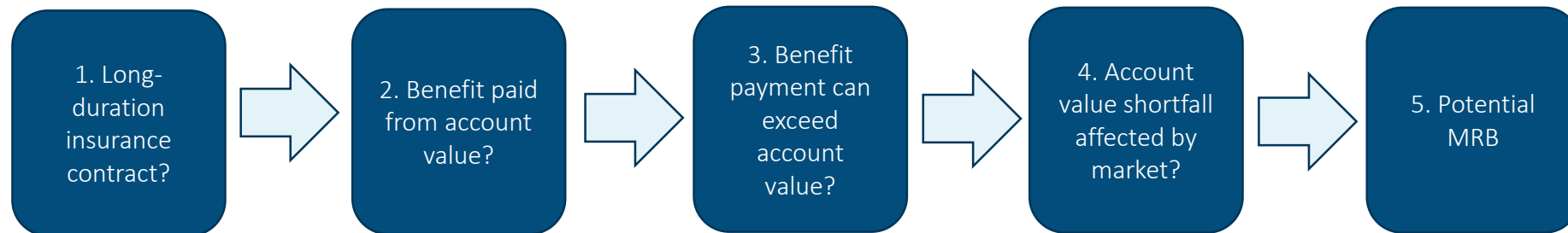
Market Risk Benefit – Definition & Scope

Market Risk Benefit definition (ASC 944-40-25-25C): A contract or contract feature that both provides *protection* to the contract holder from other-than-*nominal* capital market risk and exposes the insurance entity to other-than-*nominal* capital market risk.

ASC 944-40-25-25C:

- **Protection** refers to the transfer of a loss in, or shortfall (that is, the difference between the account value and the benefit amount) of the contract holder's account balance from the contract holder to the insurance entity, with such transfer exposing the insurance entity to capital market risk that would otherwise have been borne by the contract holder.
- **Protection** does not include the death benefit component of a life insurance contract, but would apply to death benefit coverage on an investment or annuity contract.
- **Nominal risk** is a risk of insignificant amount or remote probability of occurring. Presumed other-than-nominal if benefit would vary more than an insignificant amount in response to capital market volatility.

Is the company providing the policyholder with market risk protection?



Is the protection other-than-nominal?

Considerations: Shortfall & Quantification of Shortfall

Market Risk Benefits - Scope

Benefit Feature	Long Duration Contract?	Benefit Paid from Account Value?	Benefit Payment Can Exceed Account Value?	Account Value Shortfall Affected by the Market	MRB?
VA GMxB	Yes	Yes	Yes	Yes	MRB
FIA Index Crediting	Yes	Yes	No	N/A	Not MRB
FIA GMxB	Yes	Yes	Yes	Yes	MRB
Minimum general account interest rate guarantee	Yes	Yes	No	N/A	Not MRB
VUL DB	Yes	No	N/A	N/A	Not MRB
UL NLG	Yes	No	N/A	N/A	Not MRB
Annuity Purchase Guarantees	Yes	Yes	Yes	Yes	MRB

Market Risk Benefits - Measurement

Ascribed fee (or Attributed Fee) method for valuing GMxBs in variable annuity:

- Common approach used in practice

At inception:

- Estimate fair value of expected claims consistent with capital market valuations (e.g. stochastic risk neutral scenarios)
- Assume that total dollars of GMxB fees equal the fair value of expected claims at inception
- As Ascribed Fee is set and locked at “inception” equal to the PV of claims over the PV of fee base
- **MRB Fair Value = PV Claims – Ascribed Fee * PV Fee Base**
- **MRB fair value = Fair value expected future claims - Fair value ascribed (or attributed) fees**
- **MRB fair value = 0 at inception**
- **Fair Value of ascribed (or attributed) fees – Fair Value of claims = 0**
- **Fair Value of ascribed (or attributed) fees = Fair Value of claims**

Subsequent accounting:

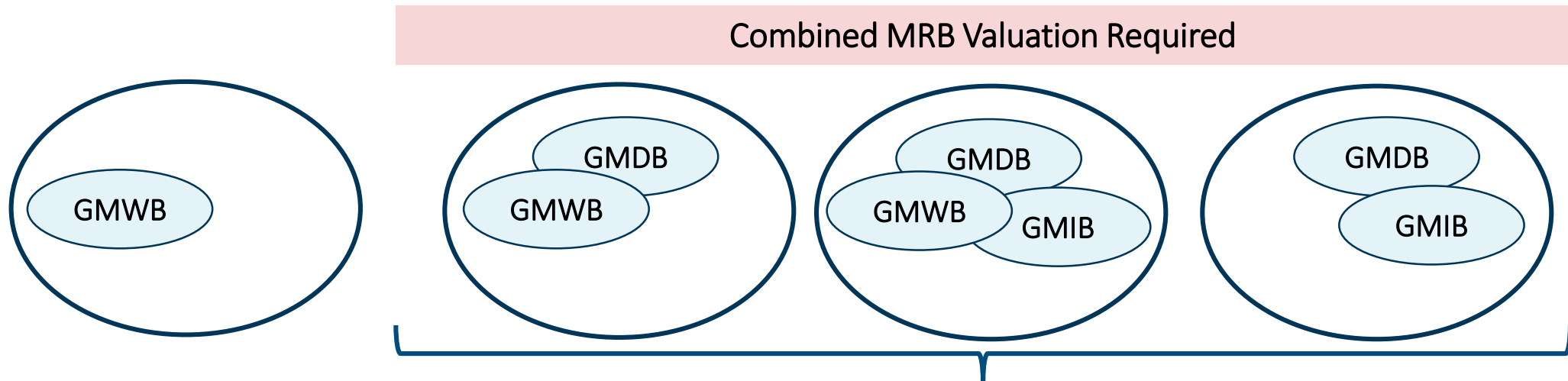
- Apply ‘locked in’ GMxB ascribed (or attributed) fee to each period’s PV total expected fee base to determine the PV of ascribed (or attributed) fees
- Ascribed (or attributed) fee may differ from contractual fee for GMxB benefit, but cannot exceed total contract fees collectible or be less than zero

Derecognition:

- Compare MRB to the liability
- If gain, deferred profit liability posted
- If loss, recognize immediately
- Other comprehensive income is released

Market Risk Benefits - Measurement

- Ascribed (or Attributed) fee method is currently most commonly used among VA carriers with GMxB embedded derivatives
- Possibility of no fees for the FIA or not enough for ascribed (or attributed fee) method
 - Potential of positive MRB at issue



How do you account for multiple market risk benefits within one contract?

- Analyze each MRB separately against scope criteria
- Separate compound MRB features from host
- Compound MRB = 1 unit of account
 - Policyholder behavior assumptions need to be relevant to the combined contract
 - Market consistent assumptions such as economic volatility need to be consistent with expectations for the combined contract

Pricing & Product Development Considerations



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**Poll: Do you have GAAP pricing targets
when developing VA/FIA?**

Market Risk Benefits - Pricing Considerations

Scenarios

- Do you have desired risk neutral **scenario generators** and **system modeling capabilities**?
- **How many scenarios** are adequate for pricing? (system constraints or first principles)

Calculations

How will **caps and fees be projected** in the risk neutral environment?

Unit of Account

- At **what level of granularity** is the calculation done for pricing (vs. valuation)?

Hedging

- Is the **cost of hedging** accounted for in the pricing process and is it modeled explicitly?
- Is there a **change in hedging strategy**? (Possible increased cost of hedging and increased breakage possible due to more benefits being hedged)
- How does a potential change in hedging strategy impact your **GAAP pricing**? **Statutory pricing**?

Market Risk Benefits - Pricing Considerations

Modeling Considerations and Simplifications

- What **modifications** will be necessary for the current models?
- How is pricing different from valuation?
 - How precise does the reserve component need to be to reasonably capture profitability?
 - What nuances can be simplified for the pricing model? What is the **impact of the simplifications**?
- **How frequently** should you run stochastic models? Can you live with **approximations** for some iterative steps?

Assumptions

- Do you need to develop **new assumption sets** for market risk benefits? (e.g. Combined MRBs)
 - Identify risk factors needed to be **stochastically modeled** (dynamic lapses, dynamic withdrawals, caps, allocation transfers)
 - Sensitivity testing (the **sensitivity to policyholder assumptions could be increased**)
 - Regular review of adequateness

Targets

- Do **pricing targets** need to be updated?
- Do **downside targets** need to be updated?
- What **risk limits/tolerances** should your pricing consider?
- How does this fit into the **capital optimization** framework?

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**Poll: Do you expect the MRB classification
to drive any changes to your pricing
targets?**

Market Risk Benefits - Product Strategy/Development Considerations

Product Mix	<ul style="list-style-type: none">• Appetite for market risk exposure• Proportion of business permitted to exposure
Product Design	<ul style="list-style-type: none">• Extent of guaranteed benefits• Adjustments based on utilization
Product Actions	<ul style="list-style-type: none">• Reevaluate product & features• Reprice products• Account for cost of hedging / model it explicitly• Continue without changes; economics of business does not change
Risk Considerations	<ul style="list-style-type: none">• Economic risk limits• Risk free rates and fund performance drive reserves• There is NO perfect hedge

Live Content Slide

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Poll: Do you expect the MRB classification to drive any changes to your products?

Concluding Thoughts

Key Potential Changes:

- Income statement and reserve balances may become more volatile
- Increased sensitivity to equity and rates for GMxB's

Key Considerations:

- Pricing/Product engagement with Valuation and Risk on accounting policy decisions, hedging strategy, scenarios, and calculation decisions
- Pricing considerations include modeling updates/simplifications, assumptions, inclusion of hedging and review of pricing targets
- Product development considerations include establishing clear risk tolerances, product mix considerations, product feature sensitivity, hedge costs and iteration toward risk appropriate offerings



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