04 - US GAAP Targeted Improvement – Accident and Health Insurance – Part I – A Conceptual Summary

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2019 Valuation Actuary Symposium

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FASB Targeted Improvement – Accident and Health Insurance – Part I – A Conceptual Summary

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Agenda

Topic	Speaker(s)	Time
▶ Overview of the Standard	Sarah Anyieth	10 minutes
▶ Key Changes by Targeted Improvement		50 minutes
▸ *Liability for future policy benefits (LFPB)*	*Sarah Anyieth*	*20 minutes*
▸ *Deferred acquisition costs (DAC)*	*Pixi Sofian*	*15 minutes*
▸ *Presentation and disclosures*	*Pixi Sofian*	*15 minutes*
▶ Q&A session	Sarah Anyieth; Pixi Sofian	30 minutes

Overview of the Standard

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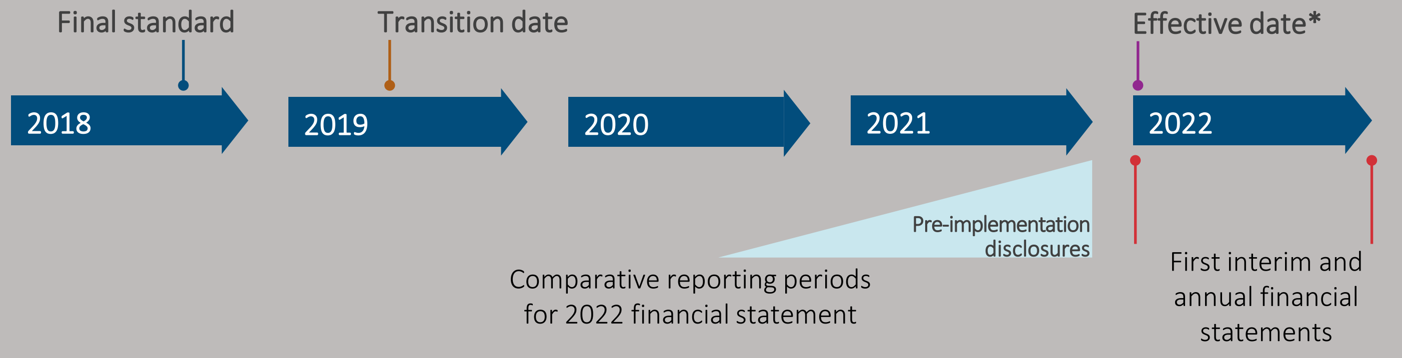
Summary of GAAP LDTI key changes

	Products impacted	Targeted improvements
Liability for future policyholder benefits	Non-par traditional long-duration and limited payment contracts	▸ Update cash flow assumptions and actual experience on cumulative catch-up basis (i.e., retrospective); impact through earnings ▸ Update discount rate assumption (i.e., single A rate) each period; impact through OCI ▸ Loss recognition testing is eliminated
Market risk benefits	Deposit products with certain benefit features (e.g., VAs, FIAs)	▸ Creates a new classification for these features ▸ Measure at fair value with changes through income (except for own credit spread impact)
Deferred acquisition costs (DAC)	All products except certain investment contracts	▸ Simplified DAC amortization; a constant basis over the life of the contract ▸ Impairment testing is eliminated
Disclosures	All long-duration products	▸ Significant new and granular disclosures ▸ New disaggregated tabular reserve roll-forwards ▸ New qualitative disclosures about significant inputs, judgments and assumptions

Timeline*

Prior to July 2019 FASB Proposed Revisions to Timeline



*For public business entities. Non-PBEs are on a one-year delay, and only one year of comparative financials may be needed if only two years of income statement activity are presented.

Where industry is today

Mobilization of resources

Impact assessments

Design and roadmaps

Implementation

Transition and parallel reporting

What has not changed

Existing ASC 944 guidance expected to be retained

- Classification of product types
- Measurement of liabilities carried at account balance
- Deferred acquisition costs
  - Identification and capitalization of costs that meet certain criteria
  - Classification of internal replacements (SOP 05-1)
  - Amortization of DAC for certain investment contracts
- Recognition of revenue
- Business combinations accounted for under ASC 944
- Areas indirectly impacted
  - Reinsurance accounting
  - Income tax accounting

Key Changes by Targeted Improvement

Liability for future policy benefits (LFPB)

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Comparison to current GAAP

*Liability for future policy benefits**

	Current GAAP	Targeted Improvements
Cash flows	▸ Assumptions and expected experience are locked into the net premium model at issuance ▸ Assumptions include provision for adverse deviation (PAD)	▸ Update cash flow assumptions and actual experience on cumulative catch-up basis (i.e., retrospective) in the net premium model ▸ Exclude maintenance expenses (claim expenses remain) ▸ Remove PADs
Discount Rate	▸ Discount rates locked into the model ▸ Rate based on the expected investment yield	▸ Rate based on the upper medium grade fixed income instrument yield (i.e., A rate) ▸ Update discount rate assumptions (i.e., single A rate) in current period (for balance sheet purposes, with no change to NPR)
Loss Recognition	▸ Loss recognition testing	▸ Loss recognition testing is eliminated (but net premium capped at 100%)
Calculations	▸ Typically a policy/cell level calculation	▸ Cohort calculation

* Liability for future policyholder benefits includes traditional long duration and limited payment contracts.

Liability for future policyholder benefits

Net premium model under new guidance

Net Premium Ratio* = [PV actual benefits + PV of projected future benefits] / [PV of actual gross premiums + PV of projected gross premiums]

Net Premium(t) = Net Premium Ratio X Gross Premium(t)

Reserve(t) = PV of future benefits – PV of future net premiums
{Use locked in rate for income statement purposes, and current rates for balance sheet purposes}

* Calculated using the locked in discount rate; recalculated whenever assumptions are updated (at least annually); may also be recalculated if actual emerging experience is reflected between assumption updates (e.g., for quarterly experience true-ups)

Liability for future policy benefits

Other changes

- Unit of account at which reserves are calculated ("cohorts")
  - Contracts from different issue years cannot be grouped when measuring the liability
  - Contracts within a single issue year may be grouped into quarterly or annual cohorts

ASC 944-40-30-7 *"…In determining the level of aggregation at which reserves are calculated, an insurance entity shall not group contracts together from different issue years but shall group contracts into quarterly or annual groups"*

- Adjustments to the results of the net premium model
  - NPR is capped at 100% (previously, the total GAAP net premium was capped at 100%)
  - Loss recognition test is eliminated
  - Liability should never be less than zero

944-40-30-7A *"To the extent the present value of future benefits and expenses exceeds the present value of future gross premiums, an immediate charge shall be recognized in net income … such that net premiums are set equal to gross premiums."*

Transition

Overview of accounting election

Election requirements	▸ Entity-wide basis decision for all contracts issued in a given issue year ▸ Align DAC transition approach with the liability for future policyholder benefits.

	Modified retrospective approach	Retrospective approach
Cash flows	▸ Update future cash flow estimates as of the transition date	▸ Update actual historical cash flows back to the transition date and future cash flow estimates from the transition date forward
Revised net premium ratio	▸ Expected future cash flows, adjusted for the reserve carry over basis at transition ▸ Retain existing discount rate used in the measurement of the liability immediately before transition	▸ Discount rate reflects upper medium grade rate at issue ▸ Estimates of historical experience shall not be substituted for actual historical experience

Transition adjustments	▸ Remove any existing amounts in AOCI
	▸ Record the effect of the current discount rate (upper-medium-grade fixed-income instrument yield) in AOCI
	▸ If revised NPR > 100%, record cumulative effect adjustment to retained earnings at transition
		▸ Cumulative catch-up adjustment to AOCI for:
		    ▸ Remove any existing amounts (i.e., shadow accounting)
		    ▸ Change in discount rate from contract issuance
		▸ Remaining changes recorded as cumulative catch-up adjustment to retained earnings

Liability for future policyholder benefits

Updating the cash flow assumptions and determining the income statement effect

Increase in reserve (for income statement purposes) =

Reserve*(t) – Reserve(t-1) =

Reserve*(t-1) – Reserve(t-1) *{Remeasurement gain or loss}*

+ Reserve*(t) – Reserve*(t-1) *{Current period benefit expense}*

where

Reserve*: Reflects updated assumptions and updated net premium ratio (NPR*)

Reserve: Reflects prior period assumptions and net premium ratio (NPR)

NPR*: Reflects actual experience through the end of the current period, projected experience after the end of the current period using updated assumptions, and the locked-in discount rate

Liability for future policy benefits

Discount rate information

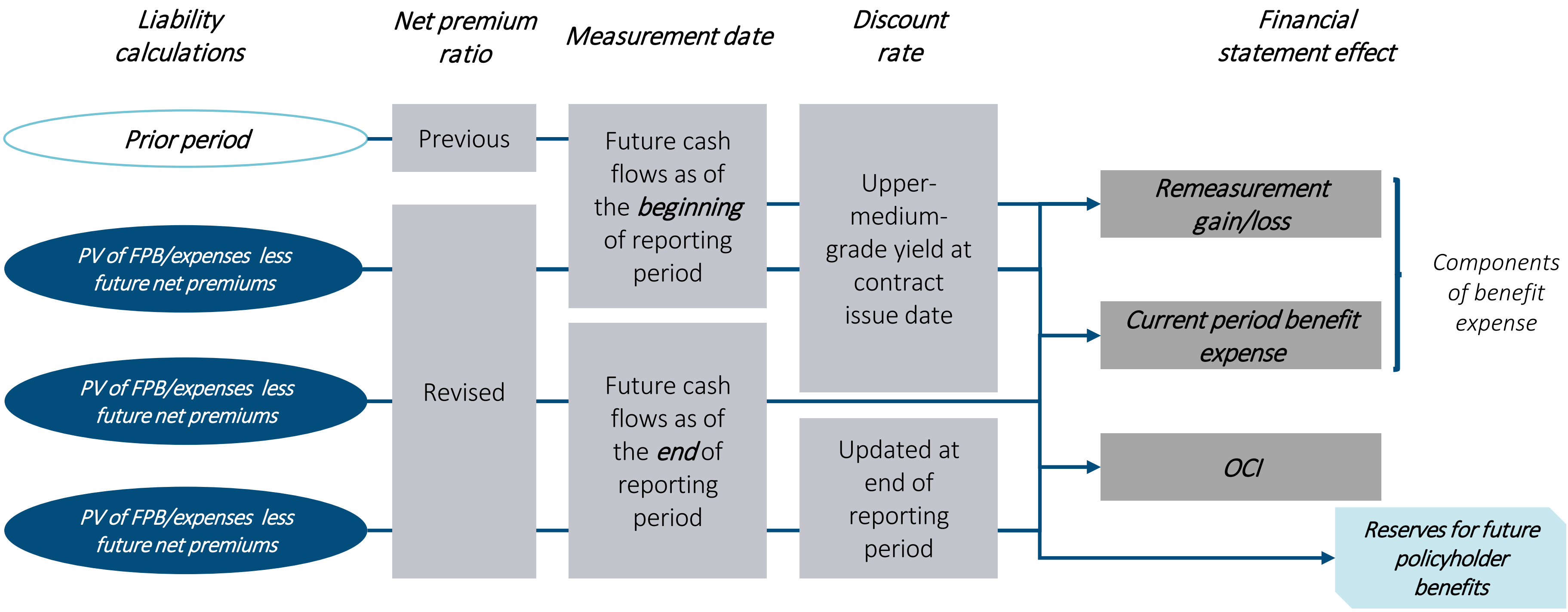
- Discount rate based on upper-medium-grade fixed-income instrument yields
  - Reflects the duration characteristics of the liability
  - Maximizes use of observable inputs

- Balance sheet liability discount rate
  - Updated to reflect current rates every reporting period
  - Effect of change recognized in Other Comprehensive Income (OCI)

- Income statement liability accretion rate
  - Uses contract inception discount rate(s) (at issue - locked in)
  - Exception for contracts transitioned under the modified retrospective method, in which case the locked in rate(s) before transition are use (remain locked in going forward)

Overview of the accounting considerations

Summary of financial statement effect of updates to the net premium model



Liability for future policy benefits

Deferred profit liability (DPL)

- The DPL is a mechanism for recognizing the profit margin embedded in the premium over the life of the contract.

- A deferred profit liability is established for **Limited-Payment contracts** where the present value of future premiums exceeds the present value of future benefits.

- ASC § 944-605-25-4A: Because the collection of premium under a limited-payment contract does not represent the completion of an earnings process, any gross premium received in excess of the net premium shall be deferred.

Liability for future policy benefits

DPL mechanics under GAAP Targeted Improvements

Amortization:

- The DPL will be recognized in income in a constant relationship with the insurance in force for life insurance contracts or with the amount of expected future benefit payments for annuity contracts.

Interest accrual:

- Interest will accrue to the unamortized balance of the deferred profit liability using the contract issuance discount rate for the related policyholder liability.

Assumption/experience updates:

- Updates to cash flow assumptions will be used to recalculate the DPL at issue as if the updated assumptions were in place at the contract issuance date. The revised DPL as of the contract issuance date is then amortized based on updated insurance in force (life contracts) or expected future benefit payments (annuities) to derive the revised DPL as of the beginning of the reporting period. The difference between the revised DPL and the previously recorded liability will be recognized as a cumulative catch-up adjustment in net income.

Note: There are special considerations for handling the DPL at transition on a modified retrospective basis

Targeted improvements

Deferred acquisition costs (DAC)

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Deferred acquisition costs (DAC)

Amortization of DAC de-linked from profit emergence and simplified

Amortization principle:

- DAC amortized on a constant level basis over the expected term of the contract(s)
- Individual contracts: Amortized on a straight-line basis
- Grouped contracts: Amortized on a constant-level basis that approximates straight-line amortization on an individual contract basis
- Profitability of the contract would not be considered
- Contracts should be grouped consistent with the grouping used to estimate the reserve
- DAC written off when actual experience exceeds expected experience

Concepts eliminated

- Accruing interest on the unamortized balance of DAC
- Adjusting DAC for the effect of investment performance or changes in expected future liability cash flows (shadow adjustments)
- Impairment analysis on DAC

IMPACT: De-links from profit emergence and simplifies amortization

Deferred acquisition costs (DAC)

Measurement

- Group vs. individual contract
- Expected contract term
- Constant level basis, relative to what?
- Actual experience consideration
- Other balances amortized like DAC
  - Capitalized sales inducements, required
  - URR, required
  - VOBA/PVFP, possibly

Challenges/questions?

Technical

Operational

Contract/contract feature specific

Deferred acquisition costs (DAC)

Transition

- Expected contract term
- Linked to method selected for liability for future policy benefits
- Modified retrospective, pivot off existing carrying amounts
- Requirement for actual information to use retrospective method
- Contract group identification
  - Prior loss recognition by contract group
- DAC on participating contracts not subject to change in accounting for liability for future policy benefits

Challenges/questions?

Technical

Operational

Product line specific

DAC Issues

AICPA Insurance Expert Panel Topics

Considerations for evaluating whether the amortization on a constant-level basis for grouped contracts approximates straight-line amortization on an individual basis

Interaction of cash flow assumption updates and DAC amortization assumption updates

Updating of DAC experience as of the beginning or end of period

Considerations for determining the "expected term of the contract"

Targeted improvements

Disclosures

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Disclosures

- ASU 2018-12 has significant new requirements for additional disclosures.

- Insurers are now required to prepare disaggregated roll-forwards for the following:
  - Liability for Future Policy Benefits
  - Policyholder's Account Balances
  - Market Risk Benefits
  - Deferred Acquisition Costs
  - Sales Inducements

- Under current GAAP, none of these roll-forwards are required. This represents a major shift towards greater granularity of an insurer's disclosures

- ASU 2018-12 does not impact the way insurers display these balances on the face of the balance sheet or income statement.

What to disclose?

Disaggregated roll-forwards of beginning to ending balances

- Liability for Future Policy Benefits
- Policy Holder Account Balances
- Market Risk Benefits
- Separate Account Liabilities
- Deferred Acquisition Costs

Qualitative and Quantitative information about transition adjustments

- Opening balance of retained earnings
- Accumulated other comprehensive income
- Net premiums exceeding gross premiums
- The establishment of a premium deficiency as required in Subtopic 944-60

Many requirements are new or more specific than current ones.

Consider implementing controls over new processes to create new disclosures required by ASU 2018-12

Example Disclosure for the Liability for Future Policy Benefits

Example Roll-forward from ASC 944-40-55-29E

- An example demonstration of the roll-forward for the liability for future policy benefits that meets certain requirements of paragraph 944-40-50-6
- The roll-forward separately breaks out changes in the present value of expected net premiums and expected future policy benefits
- The disclosure must be further disaggregated at the segment level
- The net liability for future policy benefits must be reconciled to the amount on the face of the balance sheet.
- Additional quantitative information must be disclosed even beyond this roll-forward

		December 31,			
		20X2		20X1	
		Term Life	Whole Life	Term Life	Whole Life
Present Value of Expected Net Premiums	Balance, beginning of year	$ VVV	$ VVV	$ XXX	$ XXX
	Beginning balance at original discount rate	WWW	WWW	XXX	XXX
	Effect of changes in cash flow assumptions	XXX	XXX	XXX	XXX
	Effect of actual variances from expected experience	XXX	XXX	XXX	XXX
	Adjusted beginning of year balance	XXX	XXX	XXX	XXX
	Issuances	XXX	XXX	XXX	XXX
	Interest accrual	XXX	XXX	XXX	XXX
	Net premiums collected [a]	(XXX)	(XXX)	(XXX)	(XXX)
	Derecognition (lapses)	(XXX)	(XXX)	(XXX)	(XXX)
	Ending balance at original discount rate	YYY	YYY	WWW	WWW
	Effect of changes in discount rate assumptions	XXX	XXX	XXX	XXX
	Balance, end of year	$ ZZZ	$ ZZZ	$ VVV	$ VVV
Present Value of Expected Future Policy Benefits	Balance, beginning of year	$ VVV	$ VVV	$ XXX	$ XXX
	Beginning balance at original discount rate	WWW	WWW	XXX	XXX
	Effect of changes in cash flow assumptions	XXX	XXX	XXX	XXX
	Effect of actual variances from expected experience	XXX	XXX	XXX	XXX
	Adjusted beginning of year balance	XXX	XXX	XXX	XXX
	Issuances	XXX	XXX	XXX	XXX
	Interest accrual	XXX	XXX	XXX	XXX
	Benefit payments	(XXX)	(XXX)	(XXX)	(XXX)
	Derecognition (lapses)	(XXX)	(XXX)	(XXX)	(XXX)
	Ending balance at original discount rate	YYY	YYY	WWW	WWW
	Effect of changes in discount rate assumptions	XXX	XXX	XXX	XXX
	Balance, end of year	$ ZZZ	$ ZZZ	$ VVV	$ VVV
	Net liability for future policy benefits	$ CCC	$ DDD	$ AAA	$ BBB
	Less: Reinsurance recoverable	XXX	XXX	XXX	XXX
	Net liability for future policy benefits, after reinsurance recoverable	$ XXX	$ XXX	$ XXX	$ XXX

Example Disclosure for the DAC

Example Roll-forward from
ASC 944-30-55-2

- An example demonstration of the roll-forward for deferred acquisition costs that meets certain requirements of 944-30-50-2B(a)
- In this example, the required disaggregation is shown as whole life vs. universal life vs. variable universal life
- The disaggregated roll-forward, when aggregated, must be reconciled to the statement of financial position

	As of December 31, 20X2			
	Whole Life	Universal Life	Variable Universal Life	Total
Balance, beginning of year	$ YYY	$ YYY	$ YYY	$ YYY
Capitalizations	XXX	XXX	XXX	XXX
Amortization expense	(XXX)	(XXX)	(XXX)	(XXX)
Experience adjustment	(XXX)	(XXX)	(XXX)	(XXX)
Balance, end of year	$ ZZZ	$ ZZZ	$ ZZZ	$ ZZZ

	As of December 31, 20X1			
	Whole Life	Universal Life	Variable Universal Life	Total
Balance, beginning of year	$ WWW	$ WWW	$ WWW	$ WWW
Capitalizations	XXX	XXX	XXX	XXX
Amortization expense	(XXX)	(XXX)	(XXX)	(XXX)
Experience adjustment	(XXX)	(XXX)	(XXX)	(XXX)
Balance, end of year	$ YYY	$ YYY	$ YYY	$ YYY

Transition Disclosures

SAB Topic 11.M requires public companies to disclose details of how recently issued accounting standards will affect its financial position and operations after the standard is adopted

Notable key requirements include

- Brief description of the standard
- Required and planned adoption date
- Allowed and planned adoption methods
- Impact the adoption is expected to have, including a description of effects, comparison to current policies, status of the adoption process, and significant matters yet to be completed

The SEC staff expects accounting transition disclosures to be more specific as the effective date of a new standard nears

Presentation & Disclosure Issues

AICPA Insurance Expert Panel Topics

Clarification of items within other comprehensive income as discussed in FASB ASC 220-10-45-10A(m) and 45-10A(n)

Limited payment contracts, deferred profit liability disclosure issues

Liability for Policyholders' Account Balances, including clarification on interest expense and cash surrender value as discussed in FASB ASC 944-40-50-7A

Q&A

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