Update on recent FASB exposure draft on insurance contracts reporting

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FASB recently issued an exposure draft (ED) on insurance contracts, which proposes to replace all current U.S. GAAP guidance on accounting for insurance contracts. The ED proposes some far-reaching changes to accounting for insurance contracts, with possible implementation by 2018. In this paper, we summarize the main areas of the ED and consider what it means for liability measurement.

BACKGROUND

The 2013 ED is the latest stage in a five-year joint project between the U.S.-based Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The FASB ED is intended to replace the current U.S. GAAP guidance that is focused on the insurance industry and replace it with guidance that is based on an insurance contract. The consultation period is open until October 25, 2013.

FASB has not laid out a timeline for mandatory adoption. It will do so when the final standard is released. It seems likely that a period of three years after the issue of the final standard will be necessary, recognizing the complexity of implementation. A likely timetable is for the final standard to be issued in 2015, and mandatory adoption could be as early as 2018. FASB believes that the existing insurance accounting guidance has shortcomings. Specifically:

- Current U.S. GAAP guidance includes multiple product specific models.
- Current guidance applies only to insurance entities.
- Insurance accounting has never been subjected to a comprehensive reconsideration.
- The current mixed attribute model contributes to accounting mismatches.
- Time value of money is not reflected in certain claim liabilities.
- Revenue for long-duration contracts is not consistent with recently developed principles for revenue recognition.

FASB believes that the current exposure draft addresses these problems and, as such, represents an improvement to current U.S. GAAP guidance. FASB has also specified a set of objectives for the accounting standard. They are:

- Increase decision usefulness of the information about an entity's insurance liabilities, including the nature, amount, timing and uncertainty regarding cash flows
- Faithfully represent the economics of the transaction
- Provide comparability regardless of issuing entity

The IASB has also recently published its own re-exposure draft on insurance contracts reporting. Whilst the IASB proposals and FASB proposals are similar, there are some important differences. Such differences may reduce the global comparability of insurers' accounts.

The new exposure draft is an important stepping stone toward FASB's aim for improved and comparable insurance accounting. Some of the proposed changes are far-reaching and will require significant implementation changes.

While the impact of the exposure draft on specific companies is still unclear, we encourage insurers to gain an understanding of the proposals to help shape the final outcome. They should also be aware of the wider implications on elements like pricing, financial reporting, and investor communication.

CONTRACT CLASSIFICATION

Under the proposed FASB approach, each contract an insurer issues will need to be classified for the proper accounting treatment. A contract will be classified as insurance if it contains significant insurance risk.Contracts that do not contain significant insurance risk will be classified as either a financial instrument if the contract results in a financial asset or liability on the insurer's books or a service contract if the insurer is only providing a service such as premium collection and claims payment. Typical life contract classification would be as follows:

- **Insurance contracts** – Term, whole life, universal life, VUL, LTC, DI, group term, group health, EIUL, deferred annuities with life contingent guarantees
- **Financial instruments** – GICs, funding agreements, deferred annuities with no insurance guarantees
- **Service contracts** – Administrative-services-only contracts

SHORT-TERM CONTRACTS

Where the original contract term is one year or less, insurers are required to use an alternative measurement approach often referred to as the premium allocation approach (PAA). This approach sets the pre-claims liability equal to the unearned premium liability. Claims liabilities follow the building block approach.

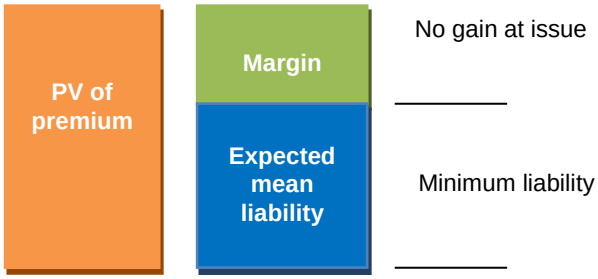
SUMMARY OF BUILDING BLOCKS APPROACH TO LIABILITY MEASUREMENT

For long-term business, FASB proposes to use a prospective gross premium valuation based on updated estimates and assumptions at each reporting date. This approach is intended to reflect the time value of money and allow for earnings to be recognized as the insurer is released from risk.

In particular, the liability measurement uses a *building block approach* that consists of:

- **Estimated mean liability (EML)** – the unbiased present (mean) value of future fulfillment cash flows discounted at current yield curve.
- **Margin** – set up to eliminate any gain at policy inception. If the present value of the premium expected to be received is lower than the EML, the margin is set to equal to zero and a loss is immediately recognized.

Figure 1: FASB Building Blocks[1]



Initial measurement

Under the proposal, there is no profit on initial recognition of a contract and this is achieved through establishing the margin. In addition, any losses are immediately recognized through net income.

The margin is measured separately for ceded reinsurance contracts and direct written insurance contracts. This potentially creates an accounting mismatch if the direct written business is, when considered in isolation, loss making but the reinsurance makes the overall new business profitable. A loss will be recognized immediately on the direct written policies, while the margin established on the reinsurance contract will eliminate any initial profit. Hence there will be a time 0 loss, despite the portfolio being profitable on an after-reinsurance basis. All losses on inception of ceded reinsurance are also deferred and recognized over the life of the reinsurance contract.

Subsequent measurement

The liability balance sheet components are re-calculated at each reporting date. For the estimated mean liability, this entails re-running the calculations with updated data and assumptions.

The margin roll forward is a material driver of the income statement. After initial recognition, it increases with interest and is amortized as the insurer is released from risk.

[1] Not to scale

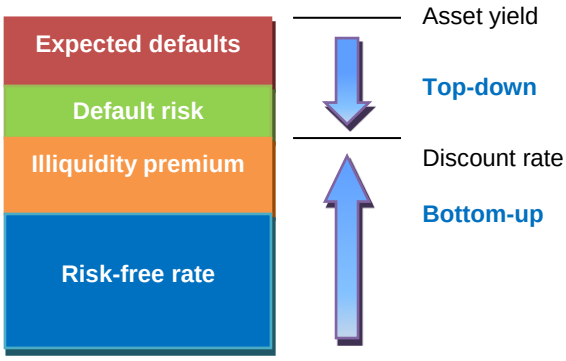
The margin is never unlocked for changes in future assumptions and hence the impact of such changes directly affects income in the period.

Discount rate(s)

The ED requires that the discount rate used must reflect the characteristics of the liability being measured and specifically notes currency, liquidity, and duration as items that need to be considered. The duration consideration implies that discount rate should vary based on the time between the valuation date and when the cash flow is expected to occur. In other words, discounting should be done with yield curves rather than level discount rates. This represents a significant change for most valuation systems and a challenge in understanding and explaining the movement of the liability from period to period.

The ED allows both top-down and bottom-up approaches to determining discount rates. Entities using a top-down approach are allowed to ignore any differences between the liquidity of assets used in determining the starting point of the yield curve and the liquidity of the liability being measured.

Figure 2: Discount Rates



Implications for earnings emergence

The margin is the main source of profit under the building block approach. Under the ED, the margin grows with interest and is to be released as the entity satisfies its performance obligation to provide insurance. Satisfaction of the obligation is evidenced by the reduction in the variability in expected cash flows. Thus, profits will emerge in proportion to the reduction in variability of expected future cash flows. Depending on how variability of cash flows is defined and calculated, insurance profit may be realized in a different pattern from current FAS 60 (as percent of premium) or FAS 97 (as percent of EGPs) accounting.

The ED cites examples of factors that an entity may consider beyond a quantitative determination of the variability: reduction in face amount, policy count, claim count, or net amount at risk. What does this mean? If you assume variability of timing around mean mortality projection is the same and there are no surrender benefit cash flows (e.g., term insurance), the reduction in face amount may be an acceptable indicator of the reduction in variability of future cash flows. For contracts with surrender benefits as well as death benefits, the indicators of reduction in variability of cash flows are likely to be more complicated. If one can assume that the variability around the mean is symmetric for all cash flows, then an acceptable indicator of the reduction in variability of cash flows may be the reduction in the net present value of expected future cash flows. When variability is asymmetric around the mean estimate, further quantification or analysis is likely to be needed. Initial modeling suggests that profit will be recognized later than under current U.S. GAAP.

Locked-in assumptions apply in income

Liability discount rates used in determining net income will be *locked in* at initial recognition. The impact of movement from initial recognition discount rates to current discount rates will be recognized through other comprehensive income (OCI). This is similar to how assets classified as *available for sale* have been accounted for under U.S. GAAP.

There will undoubtedly be significant system implications around needing to store locked-in discount yield curves in addition to current yield curves, as well as challenges in understanding and communicating the unwind of multiple yield curves in income to investors and analysts.

Some insurers believe there should be an option to recognize the effect of changes in discount through income, as this would reduce complexity and help to avoid accounting mismatches where assets used to back liabilities cannot be measured as available for sale.

Mirroring approach

Where payments to policyholders depend on underlying assets and the insurer is required to hold the underlying assets, the accounting for cash flows that vary directly with the underlying asset will follow the accounting on the underlying asset. This proposal likely affects variable (unit-linked) and some participating contracts. The aim here is to avoid accounting mismatches between the liabilities that

pass directly to the policyholder all the investment experience and the underlying assets.

The proposal may introduce complexity for participating products, as there may not be such linkage in accounting under current U.S. GAAP. Furthermore, under the proposals, all changes to the value of shareholders' share of the underlying assets appear to flow through directly to income, which could create additional balance sheet volatility.

Variable contracts will also be affected. However, there will be certain cash flows such as mortality and expense charges (M&E) to which mirroring will not apply. These cash flows and associated outflows will have to follow the building block approach of the proposed insurance standard.

Revenue recognition no longer linked to written premium

Revenue will be recognized as services are delivered to the policyholder. While similar in concept to the margin-based approach of FAS 97, it has some important differences. The revenue will be equal to the reserve released in the period to cover expected benefits and claims, plus the release of the margin.

The revised approach is in line with FASB's draft conceptual approach to revenue recognition. However, there may be practical issues with implementation, as revenue will no longer be linked to typical cash ledger items. Furthermore, explanation of results to key stakeholders may become more challenging.

TRANSITION

At transition, for in-force business, the existing liability and related DAC and VOBA will be de-recognized and replaced with a liability consisting of the building blocks outlined above. The ED allows various simplifications in the calculation of the liability components for in-force business. This appears to be a pragmatic approach that will give users of the accounts useful information. However, this may still be a significant effort for insurers. A balance of OCI will need to be determined as of the transition date. This will require insurers to determine the discount rate that would have been locked in at issue as well as the date of transition.

While modeling for new business seems to indicate that profits will be realized later under the proposal versus current U.S. GAAP, it does not necessarily mean that in-force equity will be lower at transition.

Complicating this is the fact that interest rates have generally declined over the last 20 years, which would give rise to substantial amounts of OCI on long-tail liabilities. Much of the OCI may still be outstanding and is yet to be recycled into income at transition. This would tend to increase liabilities and decrease equity. The same economics would affect the assets backing the liabilities, but it is possible that more of the gains on the assets have been realized. That is, since the assets typically have a shorter duration than the liabilities, companies may have actively managed the assets to recognize the gains. Companies will need to model their own assets and liabilities in order to analyze the potential impact. If more asset gains have been realized and fewer remain in OCI, future income could be reduced as the OCI on the liabilities is recycled into income.

CONCLUSION

The ED is an important milestone in the history of U.S. GAAP accounting for insurance project. Some of the proposals are significant changes to current U.S. GAAP accounting. The actual impact on any particular company will not be clear without specific analysis. We encourage all companies to evaluate the likely impact on both in-force and new business.

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