MILLIMAN WHITE PAPER

U.S. GAAP targeted improvements for long-duration insurance contracts: Update II

What needs to be considered?

William C. Hines, FSA, MAAA
Karthik M. Yadatore, FSA, MAAA

The Financial Accounting Standards Board (FASB) has made significant revisions to its proposed changes to the accounting for long-duration insurance contracts, originally defined in the exposure draft released in September 2016. The board met several times in 2017 to deliberate upon the comments received in response to the exposure draft and to affirm, clarify, or make changes to the proposal. The current status of the proposed amendments to the accounting for long-duration insurance contracts is summarized below.

FASB consideration of comments

FASB released an exposure draft in September 2016, in which it proposed significant changes to the accounting of long-duration insurance contracts to address stakeholders' key concerns. The board has spent much of 2017 redeliberating several key issues raised by stakeholders during the comment period. As of the publish date of this paper, FASB has discussed the insurance project five times, the latest being November 1. Several key decisions were made at these meetings that change the elements of the original proposal. In this document we summarize the original proposal and outline the key changes made during the re-deliberations.

Background: Summary of the original proposed *changes* in the exposure draft

FASB proposed changes to the accounting for long-duration insurance contracts in four major areas.

1. FASB proposed updating all assumptions to a current basis at each valuation date and eliminating all provisions for adverse deviation (PADs) when reserving for nonparticipating traditional contracts (formerly known as "FAS 60") and traditional participating contracts. In addition, FASB proposed that the discount rate for these contracts be based on the yields of "high quality fixed income instruments," with the impact of changes in discount rates reflected in "Other Comprehensive Income" (OCI) instead of operating income. The impact of changes in all other assumptions would be recognized in profit and loss.
2. FASB proposed that Deferred Acquisition Costs (DAC) assets for all products be amortized in proportion to insurance or benefits in-force and that no interest accrue on the outstanding DAC balance. In addition, the requirement to perform loss recognition testing would be removed.
3. FASB proposed that all guaranteed benefits provided in excess of the account value (GMxBs), for separate account products only, be measured at fair value, with the changes in the fair value that are due to changes in own credit risk being reflected in OCI.
4. FASB proposed material improvements in disclosures.

FASB proposed full retrospective application of the new accounting standard at transition, with the exception of DAC. FASB proposed that DAC be set to the then existing balance at the time of transition, and henceforth amortized according to the new rules.

Liability for nonparticipating traditional and limited payment contracts

FASB has decided to make changes to the assumption setting and discount rate determination for nonparticipating traditional and limited payment contracts.

Cash-flow assumptions

At the meeting of August 2, 2017, FASB affirmed that the cash-flow assumptions used to measure the liability for future policy benefits, for *nonparticipating traditional and limited-payment contracts only*, should be updated to current best estimates and the impact be recognized in net income. Assumptions need to be reviewed and updated if appropriate on an annual basis, at the same time every year, or more frequently in interim reporting periods if evidence suggests that previous assumptions should be revised. FASB decided that updating the expense assumption would no longer be required but could be updated at the election of the company.

When assumptions (other than discount rates) are updated, a revised net premium ratio will be calculated using actual historical experience, the updated future period cash-flow assumption, and the discount rate that applied at inception of the contract. The revised net premium ratio is applied from issue to determine the revised liability as of the valuation date. The difference in the liability under the old and new net premium ratios would be reflected in current period operating income.

FASB affirmed that PADs would be eliminated for nonparticipating traditional and limited-payment contracts.

Discount rates

FASB confirmed that the discount rate should be updated at each reporting date and the impact of updating it should be recognized in the OCI. The impact of the change to the current discount rate would be determined using net premium ratio determined with the discount rate applicable at inception. However, FASB changed the target for calibrating the discount rate from a "high quality fixed income yield" to an "upper medium grade (low credit risk) fixed income instrument yield." The U.S. Securities and Exchange Commission (SEC) has interpreted "high quality fixed income yield" to mean AA corporate bond yields. The FASB received a large amount of feedback that such a low discount rate is not consistent with the average credit quality of an insurer's asset portfolios or the credit rating of the industry in general. Using AA-rated corporate bond yields would result in a much more conservative level of reserve liabilities than currently exists under U.S. GAAP. The insurers argued that the feedback from stakeholders was to move to a more current view of the liabilities, not a more conservative view. FASB was sympathetic to some of the arguments and revised the target to be "upper medium grade (low credit risk) fixed income instrument yield." While FASB has not provided much in the way of guidance on interpreting this wording, many industry participants have been advocating using discount rates that are closer to A-rated corporate bond yields.

Despite the above updates, the inconsistency between the net premium ratio and the discount rate used to calculate the reserves for the balance sheet will continue to exist.

Participating contracts

FASB had proposed to apply the valuation model for traditional nonparticipating contracts to participating insurance contracts.

The board received a significant number of comments that the proposed approach would cause an internal inconsistency in the measurement when the discount rate is no longer linked to the dividend payments and related cash flows.

Given the strong concerns, during the October 4, 2017, meeting, *FASB voted to retain the existing guidance for the liability for future policy benefits for participating insurance contracts*. Current accounting for such contracts requires a benefit reserve using a net premium valuation based on the assumption underlying the dividend fund, or the guaranteed nonforfeiture basis if there is no underlying dividend fund. Current or anticipated experience, including estimated policyholder dividends, is not explicitly included in the valuation.

Loss recognition

FASB had proposed that the net premium ratio should be capped at 100% of the gross premium and that the premium deficiency tests be eliminated. FASB affirmed this for traditional nonparticipating contracts.

FASB had also proposed the elimination of loss recognition for all other long-duration insurance contracts. *However, the board clarified that loss recognition testing should be retained for universal life-type contracts*. FASB has decided to retain the existing guidance for liability measurement and provided no explicit exception to the loss recognition testing for participating contracts. Hence, we believe that loss recognition testing for participating contracts will continue to apply.

Deferred Acquisition Costs

FASB originally proposed to simplify the amortization of DAC for all types of contracts by amortizing it in proportion to the in-force amount of insurance or benefits for annuities and no longer accruing interest on the DAC balance. Insurers would no longer need to calculate estimated gross profits (EGPs) or estimated gross margins (EGMs). Other asset and liability balances that are currently amortized consistent with DAC amortization (such as sales inducements and unearned revenue) would likewise have their amortization changed to the new methodology.

During the meeting of October 4, 2017, FASB affirmed its decision to simplify the amortization of DAC. However, based on feedback from stakeholders that, for a significant number of contract types, it is difficult to define the amount of insurance in-force, FASB decided instead to define the following principle: DAC would be amortized on a constant basis over the expected life of the contract. It will be up to the reporting entity to determine the actual basis to be used, but FASB does expect more DAC to be amortized when more business terminates in the period relative to expected.

Guaranteed benefits creating market risk

FASB had proposed that market risk benefits from "separate account" products that expose insurers to capital market risk be measured at fair value. FASB uses the term "market risk benefits" to describe the GMxBs on separate account products that meet two criteria:

1. The contract must allow the contract holder to direct funds to one or more separate account investment alternatives and the investment performance, net of fees, is passed through to the contract holder.
2. The insurance entity provides a benefit protecting the contract holder from adverse capital market performance that exposes the insurer to other than nominal capital market risk.

FASB recognized that an inconsistency will be created when measuring certain GMxBs from non-separate account products such as fixed indexed annuities. The feedback it received was that GMxBs on these products should also be in scope. As a result, at the October 4[t] 2017, meeting, FASB voted to expand the market risk benefit scope to include general account deposit (or account balance) products, for example fixed indexed annuities. FASB has directed its staff to present the revised market risk benefits criteria that would cover general account products at a future meeting and that is still being developed.

With all GMxBs treated as embedded derivatives and required to be measured at fair value, the number of contracts with multiple embedded derivatives may increase. U.S. GAAP requires multiple derivatives within a single contract to be measured on a combined basis. For example, a fixed indexed annuity with a guaranteed minimum withdrawal benefit (GMWB) rider may have two embedded derivatives that need to be combined for measurement purposes: the index feature in the base contract and the GMWB rider.

FASB affirmed its original proposal to reflect the change in fair value that is attributable to changes in the entity's own credit risk in OCI. All other changes to the fair value will flow through the operating income.

Transition

FASB originally proposed a full retrospective application of the new accounting guidance with a cumulative catch-up adjustment to the opening balance of retained earnings, reflecting actual historical experience information since contract inception.

During the meeting of August 2, 2017, FASB voted that an insurance entity would instead apply the proposed amendments to all contracts in-force on the basis of its existing carrying amounts at the transition date. FASB clarified that entities will have the option to apply the changes retrospectively as originally proposed.

The opening retained earnings balance will continue to be adjusted to the extent the net premium ratio exceeds 100%. However, because there is no requirement to apply the proposed changes retrospectively, there would be no past changes in discount rates to be reflected in OCI.

If an entity chooses to apply a full retrospective approach, the entity must:

- Apply the proposed changes at the issue-year contract grouping level and apply them to all contract groups for that issue year and all subsequent issue years
- Recognize in accumulated OCI the cumulative effect of changes in discount rates between the contract inception date and the transition date.

FASB further clarified that, when unlocking assumptions during transition or updating them periodically, contracts from different issue years should not be grouped. Instead, contracts issued within a single issue year may be grouped when determining the level of aggregation for measuring the liability for future policy benefits.

During the October 4, 2017, meeting, FASB voted to align the DAC transition with the transition guidance for the liability for future policy benefits. Adjustments for the removal of any related amounts in accumulated OCI, such as shadow DAC adjustments, will continue to apply. Similar to the liability valuation an insurance entity would have the option to apply the proposed

amendments retrospectively. However, the same transition method would have to be applied to both the liability for future policy benefits and DAC (at the same issue-year level and applied entity-wide for that issue year and all subsequent issue years).

FASB had originally proposed that the difference between the fair value (excluding the cumulative change in own credit risk) and the carrying value at transition would be an adjustment to retained earnings. However, during the meeting of October 4, 2017, FASB decided that in applying the proposed amendments retrospectively the entity would be allowed to use hindsight, i.e., actual historical experience. FASB affirmed that for market risk benefits, the cumulative effect of changes in the entity's own credit risk between the contract inception date and the transition date should be recognized in accumulated OCI.

Presentation and disclosure

FASB's original proposed changes to disclosures are significantly more involved than those currently required. During the November 1, 2017, meeting, FASB affirmed many requirements and modified some of the proposed requirements.

Disaggregated roll-forwards of the liability balances will be required along with additional information about estimates and judgments, how they have changed, and their effect on the measurement of the liability. Additional information such as cash surrender value, net amount at risk, and fees collected for the benefits will need to be disclosed.

FASB affirmed that the market risk benefits are to be shown as a separate line item on the balance sheet and that the change in the carrying amount (excluding the change due to own credit risk) is to be shown as a separate line item on the income statement.

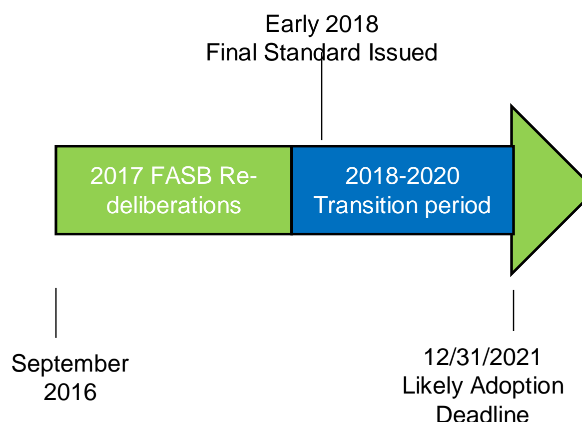
For general account-value-based products, balances need to be presented based on ranges of combinations of minimum guaranteed rates and current credited rates.

A separate roll-forward of the DAC—and sales inducement assets (SIA)—from the beginning balance to the ending balance for the period will need to be disclosed, along with inputs and assumptions used to determine the amortization.

Timeline

We expect FASB to release a final standard early in 2018, perhaps as early as the first quarter.

FIGURE 1: EARLIEST TIMELINE



Conclusion

Over 2017, FASB has made amendments to, and provided clarification for, many of the original proposed changes. We believe the proposed changes will have a significant impact on the measurement of liabilities, DAC, and earnings emergence for a large portion of the life insurance and annuity products issued by insurers.

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

milliman.com

CONTACT
William Hines
william.hines@milliman.com

Karthik Yadatore
karthik.yadatore@milliman.com

© 2017 Milliman, Inc. All Rights Reserved. The materials in this document represent the opinion of the authors and are not representative of the views of Milliman, Inc. Milliman does not certify the information, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.