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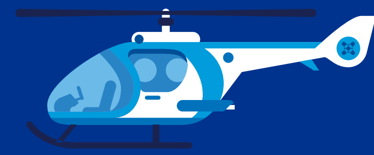

Defining Issues®

FASB makes decisions on targeted improvements for long-duration insurance contracts

August 9, 2017

KPMG reports on the FASB's redeliberations over nonparticipating traditional and limited-payment long-duration insurance contracts.[1]

Applicability

Insurance entities in the scope of US GAAP guidance on accounting for nonparticipating traditional and limited-payment insurance contracts, excluding holders of insurance contracts and non-insurance entities.[2]

Key facts and impacts

The Board's redeliberations focused on the reserving model for nonparticipating traditional and limited-payment insurance contracts. The Board made these decisions.

— Affirmed that insurance entities would be required to update cash flow assumptions at least annually, and **remeasure the liability for future policy benefits using a catch-up method** (previously called the retrospective method).

— Decided that an **upper-medium grade, fixed-income instrument yield would be used to discount future cash flows** instead of a high-quality grade, fixed-income instrument yield.

— Decided that insurance entities would apply a **prospective transition approach** instead of the retrospective transition approach initially proposed, but would have an option to use a retrospective transition approach.

Updating cash flow assumptions used in measuring the liability

Proposed ASU	Tentative Board decisions
Assumptions used to measure the liability for future policy benefits for nonparticipating traditional and limited-payment contracts should be updated.	Affirmed previous decisions, and clarified what method should be used to update expense assumptions.
The effect of assumption changes should be calculated, and the liability remeasured, using a catch-up method (retrospective approach).	Affirmed previous decision, but changed the name to catch-up method.

[1] Proposed ASU, Targeted Improvements to the Accounting for Long-Duration Contracts

[2] ASC 944, Financial Services – Insurance

Proposed ASU	Tentative Board decisions
Cash flow assumptions should be reviewed and updated on an annual basis, at the same time every year, or more frequently in interim reporting periods if evidence suggests that earlier cash flow assumptions should be revised.	Affirmed previous decision, and clarified that updating the future cash flow assumptions for actual experience at each interim reporting period would not be required but would be a matter of judgment.
Would eliminate the provision for risk of adverse deviation and premium deficiency tests, and would cap the net premium ratio at 100 percent so losses would not be deferred into future periods.	Affirmed previous decision.
The expense assumptions used to measure the liability for future policy benefits for nonparticipating traditional and limited-payment contracts should be updated consistently with the update methodology used for other cash flow assumptions.	Decided to permit, but not require, updating expense assumptions consistently with the update methodology used for other cash flow assumptions.
The proposed ASU did not address the level of aggregation for measuring the liability for future policy benefits.	Clarified that contracts from different issue years should not be grouped together. Contracts issued within a single issue year could be grouped when determining the level of aggregation for measuring the liability for future policy benefits.

Measuring the liability for future policy benefits

Under current US GAAP, the liability for future policy benefits for nonparticipating, traditional and limited-payment contracts is measured using the assumptions that existed at contract issuance. They are not updated unless a premium deficiency occurs. The liability also includes a provision for risk of adverse deviation in the event that unfavorable deviations from assumptions occur.

Catch-up method required for changes

The proposed ASU would require that an insurance entity update its cash flow assumptions at least annually and remeasure the liability using a catch-up method. The Board previously referred to this method as the retrospective approach.

This method would calculate a revised net premium ratio as of contract inception using actual historical experience and updated future cash flow assumptions. The revised net premium ratio would be applied to derive a catch-up adjustment that would be recorded in current period earnings. In subsequent periods, the revised net premium ratio would be used to accrue the liability.

Due to the anticipated incremental costs of implementing the catch-up method, the Board discussed whether an alternative assumption update method should be allowed.

The Board discussed a prospective deferral method that would require an insurance entity to update its future cash flow assumptions. A revised net premium ratio would be calculated based on the updated assumptions and would be used to accrue the liability in subsequent periods.

Another alternative would have retained the existing locked model and improved the premium deficiency test. The Board decided that the catch-up method best achieved the purpose of updating the liability and affirmed that it would retain the catch-up method from the proposed ASU.

Cash flow assumptions

The Board clarified that an insurance entity would not be required to update the net premium ratio every reporting period if actual experience differed from estimated assumptions.

The Board acknowledged that there would be differences between actual experience and the estimated assumptions used in the model, but clarified that updates to the future cash flow assumptions at interim periods would be made based on judgment.

Provision for risk of adverse deviation and premium deficiency tests

The Board affirmed that the provision for risk of adverse deviation and premium deficiency tests would be eliminated for nonparticipating traditional and limited-payment contracts.

The Board also clarified that the premium deficiency, or profits-followed-by-losses (PFBL), testing guidance in current US GAAP would be retained for universal life-type contracts. Therefore, an insurance entity would continue to perform a PFBL assessment at contract inception for universal life-type contracts.

In subsequent reporting periods, an insurance entity would not reassess whether profits are followed by losses.

Expense assumptions

The Board also clarified that an insurance entity would be permitted, but not required, to update the expense assumptions consistently with the update methodology that it used for other cash flow assumptions.

The Board decided an insurance entity could use the expense assumptions that existed at contract issuance. The unlocking of the expense assumptions would have been largely an allocation exercise that could have been expensive to operationalize, and would have provided little valuable information because unlocking the expense assumptions would have significantly less effect on the liability for future policy benefits.

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Discount rate used in measuring the liability

Proposed ASU	Tentative Board decisions
Future cash flows should be discounted using a current high-quality grade, fixed-income instrument yield.	The discount rate should use an upper-medium grade, fixed-income instrument yield.
The discount rate assumption should be updated at each reporting date.	Affirmed previous decision.
The effect of updating the discount rate assumption should be recognized immediately in other comprehensive income.	Affirmed previous decision.

Under current US GAAP, the discount rate assumptions used for nonparticipating traditional and limited-payment insurance contracts are based on expected investment yields at the contract issue date.

The proposed ASU would require that future cash flows be discounted using a current high-quality grade, fixed-income instrument yield.

The Board discussed whether an alternative discount rate other than the high-quality grade, fixed-income instrument yield should be used due to the concerns about day 1 losses.

The Board discussed four alternative methods:

- upper-medium grade, fixed-income instrument yield;
- a rate that reflects the characteristics of the liability (principles-based approach);
- current US GAAP (expected investment yield); and
- high-quality grade, fixed-income instrument yield.

The Board decided that using an upper-medium grade, fixed-income instrument yield would be most consistent with the characteristics of the liability.

Transition

Proposed ASU	Tentative Board decisions
An insurance entity would apply the proposed amendments retrospectively as of the beginning of the earliest period presented. If it is impracticable to apply the proposed amendments retrospectively, they could be applied prospectively.	Decided that an insurance entity would apply the proposed amendments using a prospective approach at transition with an option for retrospective application.

The proposed ASU would require an insurance entity to apply the proposed amendments retrospectively unless it is impracticable. An insurance entity would make a cumulative catch-up adjustment to the opening balance of retained earnings as of the beginning of the earliest period presented (transition date).

The Board discussed whether an alternative transition method other than the retrospective approach should be used because of concerns about the availability of the historical data and anticipated incremental costs to implement this method.

The Board discussed four alternative methods:

(1) retrospective approach with a lower impracticability threshold, which focused on whether an insurance entity has actual historical information readily available;
(2) prospective approach at transition;
(3) prospective approach at transition with an option for using the retrospective transition approach; and
(4) retention of the transition guidance in the proposed ASU.

The Board decided to require the third method.

Next steps

The Board will discuss at future meetings the other targeted improvement areas in the proposed ASU:

— assumptions used to measure the liability for participating insurance contracts;
— measurement of market risk benefits;
— amortization of deferred acquisition costs; and
— presentation and disclosures.

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KPMG's Financial Reporting View
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