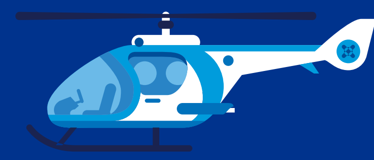

Defining Issues®

FASB continues discussion on targeted improvements for long-duration insurance contracts

October 10, 2017

KPMG reports on the FASB's redeliberations over participating insurance contracts, deferred acquisition costs and market risk benefits for long-duration insurance contracts.[1]

Applicability

Insurance entities in the scope of US GAAP guidance on accounting for participating insurance contracts, deferred acquisition costs (DAC) and contracts with market risk benefits, excluding holders of insurance contracts and non-insurance entities.[2]

Key facts and impacts

The Board's redeliberations focused on the reserving model for participating insurance contracts, DAC and market risk benefits. The Board decided to:

- **retain existing guidance on the liability measurement** for participating insurance contracts;
- **replace the DAC amortization method with a principle** in which DAC would be amortized on a constant basis over the expected life of the contracts with no linkage to the profit of the contracts;
- use a **prospective transition approach** for DAC, with an option to use a retrospective transition approach;
- **expand the scope of market risk benefits** to include general account deposit (or account balance) products;
- affirm that **market risk benefits should be measured at fair value** with changes in fair value due to instrument-specific credit risk presented in other comprehensive income and the remaining changes presented in net income; and
- clarify that **hindsight could be used for market risk benefit transition**, and affirm that an insurance entity would apply a retrospective transition approach.

Participating insurance contracts

Proposed ASU	Tentative Board decisions
Participating insurance contracts would follow the same accounting model as nonparticipating traditional contracts.	Decided to retain existing guidance on liability measurement for participating insurance contracts and to enhance disclosures. The proposed DAC amortization simplification would apply to participating insurance contracts.

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

[2] ASC 944, Financial Services – Insurance

Under current US GAAP, the future policy benefits liability for participating insurance contracts is measured using a separate accounting model that is different from the model used for nonparticipating insurance contracts.

The proposed ASU would have required that participating insurance contracts follow the same accounting model as nonparticipating insurance contracts. In addition, an assumption for expected dividend payments, discounted at the same rate as other cash flow assumptions, would have been included in the measurement of the liability.

The Board discussed the different characteristics of participating and nonparticipating insurance contracts and whether the proposed ASU would properly reflect the economics of participating insurance contracts. The Board also discussed if this change could result in unnecessary incremental costs for contracts held in a closed block.

The Board decided to retain the existing guidance on liability measurement and to enhance disclosures. However, the simplified DAC amortization model would still be used for participating insurance contracts. Enhancements to disclosures will be discussed at a future meeting.

Deferred acquisition costs

Proposed ASU	Tentative Board decisions
DAC would be amortized in proportion to the amount of insurance in force or on a straight-line basis if the amount of insurance in force over the expected term of the related contract could not be reasonably estimated.	Decided that the DAC amortization method would be replaced with a principle in which DAC would be amortized on a constant basis over the expected life of the contracts without consideration of contract profitability.
An insurance entity would write off DAC when the related contract unexpectedly terminates, without consideration of contract profitability.	Affirmed previous decision.
An insurance entity would apply the proposed ASU to the existing DAC carrying amounts on a prospective basis.	Decided that an insurance entity would apply the proposed ASU using a prospective approach at transition with an option for retrospective application.

Simplification of DAC amortization

Under current US GAAP, DAC is amortized in proportion to premiums, gross profits or gross margins.

The proposed ASU would simplify the amortization of DAC by requiring an insurance entity to amortize DAC in proportion to the amount of insurance in force or on a straight-line basis if the amount of insurance in force over the expected term of the related contract could not be reasonably estimated. When determining the expected amortization period, an insurance entity would consider assumptions such as mortality, morbidity and persistency.

The Board discussed whether an alternative approach to amortize DAC should be used because the term *insurance in force* may be too narrow and could not be applied to a wide range of products that are issued by insurance entities.

The Board decided to replace the DAC amortization method in the proposed ASU with a principle in which DAC would be amortized on a constant basis over the expected life of the contract without considering the profitability of the contract.

The Board acknowledged that the proposed ASU is silent on grouping of contracts for the amortization of DAC but that the principle would enable grouping of contracts.

The Board also affirmed the guidance in the proposed ASU that an insurance entity would periodically update its future assumptions by adjusting the remaining DAC amortization pattern, would not accrue interest to the unamortized balance of capitalized acquisition costs, and would not include future contract renewal expenses in amortization expense before those costs are incurred.

The Board discussed whether explicit guidance should be provided for certain balances that are amortized on a basis consistent with DAC when no explicit amortization guidance exists (e.g. fair value of insurance liabilities acquired).

The Board decided that it would not prescribe guidance related to these balances, but did acknowledge that if an insurance entity has an accounting policy to amortize these balances consistent with DAC, then it would not be precluded from using the new DAC amortization approach under the proposed ASU.

DAC write-off for unexpected contract terminations

The proposed ASU would require an insurance entity to reduce the DAC balance for actual experience in excess of expected experience resulting from unexpected contract terminations. An insurance entity would periodically update its future assumptions and adjust the remaining DAC amortization pattern.

Due to the anticipated reduction in complexity and the Board's rationale that a long-duration contract is akin to a financing arrangement, and therefore DAC is analogous to debt issuance costs that do not have a recoverability test, the Board decided to affirm its previous decision to require an insurance entity to write off DAC when the related contract unexpectedly terminates and no impairment analysis is required.

Transition

The proposed ASU would have required an insurance entity to apply the amortization guidance to the existing DAC carrying amount at the transition date on a prospective basis.

To align the DAC transition method with the transition method for the liability for future policy benefits decided at the August 2, 2017 Board meeting, the Board decided to require a prospective approach at transition with an option to use the retrospective transition approach.

The insurance entity would be required to use actual historical experience information when applying the proposed ASU retrospectively. For consistency, an insurance entity would be required to elect the DAC transition method option at the same issue-year level elected for the liability for future policy benefits on an entity-wide basis for that issue year and all subsequent issue years.

Market risk benefits

Proposed ASU	Tentative Board decisions
An insurance entity would measure all market risk benefits at fair value.	Affirmed previous decision.
Changes in fair value, except for changes due to instrument-specific credit risk, would be presented in net income. Changes in fair value due to instrument-specific credit risk would be presented in other comprehensive income.	Affirmed previous decision.
Limited the definition of a market risk benefit to separate account products.	Decided to expand the scope of market risk benefits to include general account deposit products.
An insurance entity would apply the proposed ASU retrospectively as of the beginning of the earliest period presented.	Affirmed the previous decision, and clarified that an insurance entity would be allowed to use hindsight.

Expanded scope

The proposed ASU would require an insurance entity to measure all market risk benefits at fair value. The portion of any change in fair value attributable to a change in the instrument-specific credit risk would be recognized in other comprehensive income.

A market risk benefit would be defined as a long-duration contract benefit that meets two criteria:

- the contract holder has the ability to direct funds to one or more separate account investment alternatives maintained, and investment performance, net of contract fees and assessments, would be passed through to the contract holder; and
- the insurance entity provides a benefit that protects the contract holder from adverse capital-market performance, which would expose the insurance entity to other-than-nominal capital market risk.

The Board discussed whether life-contingent benefits, such as benefits payable upon death, should be excluded from the scope of market risk benefits due to the existence of mortality risk.

The Board also discussed whether benefits in general account deposit (or account value) products (e.g. fixed-indexed annuities) should be included in the scope of market risk benefits because these benefits are similar to separate account products.

The Board discussed four alternatives:

- reduce the market risk benefits scope to exclude benefits payable upon death;
- expand the market risk benefits scope to include general account deposit (or account value) products;
- combine the first two alternatives; and
- retain the market risk benefit guidance in the proposed ASU.

The Board decided to require the second alternative. However, the Board directed the staff to prepare draft wording and a basis for conclusions and present it in a public Board handout when the staff discusses disclosures.

Transition

The proposed ASU would require an insurance entity to apply the new guidance retrospectively as of the beginning of the earliest period presented with the:

- difference between fair value and carrying amount at the transition date, excluding changes in instrument-specific credit risks recognized as an adjustment to opening retained earnings; and
- cumulative effect of changes in instrument-specific credit risk recognized in accumulated other comprehensive income.

The Board discussed whether a transition method other than the retrospective approach should be used because the retrospective approach would require hindsight.

The Board discussed two alternatives:

- retrospective transition with the ability to use hindsight; and
- retention of the transition guidance in the proposed ASU.

The Board decided to allow an insurance entity to use hindsight.

Next steps

The Board will discuss at future meetings presentation, disclosures and effective date.

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