Issues & Trends In Insurance

October 2016, No. 16-6

FASB Proposes Targeted Improvements for Long-Duration Insurance Contracts

The FASB recently proposed changing how insurance entities recognize, measure, present, and disclose long-duration insurance contracts.[1] The proposed Accounting Standards Update (ASU) would apply to only those insurance entities within the scope of U.S. GAAP guidance on accounting for insurance contracts, and would exclude holders of insurance contracts and non-insurance entities.[2]

Contents

Key Facts

The primary proposed improvements for long-duration insurance contracts address:

- ***Liability for Future Policy Benefits*** – Updating cash flow assumptions at the same time every year, unless experience requires more frequent updates, and updating quarterly the high-quality, fixed-income instrument yield used for the discount rate.
- ***Market-Risk Benefits*** – Simplifying and improving the accounting for certain options or guarantees embedded in variable products.
- ***Deferred Acquisition Costs*** – Simplifying the amortization process.
- ***Disclosures*** – Improving the effectiveness of disclosures about the liability for future policy benefits, policyholder account balances, market-risk benefits, deferred acquisition costs, and separate account assets and liabilities.

Key Impact

- The proposed changes will significantly affect the financial statements of insurance entities. Additionally, insurance entities should consider what effective date would be practical and communicate their concerns about transition, including the cost and complexity of adopting the proposed ASU. The FASB will hold a public roundtable at the end of the first quarter of 2017.

[1] FASB Proposed ASU, Targeted Improvements to the Accounting for Long-Duration Contracts, available at www.fasb.org.

[2] FASB ASC Topic 944, Financial Services – Insurance, available at www.fasb.org.

Comparison with U.S. GAAP

A comparison of the proposed ASU with U.S. GAAP is included as an Appendix.

Liability for Future Policy Benefits

Cash Flow Assumptions. The FASB decided to retain a net premium reserving model, but entities would be required to update all cash flow model assumptions at the same time each year. Entities also would be required to monitor the actual experience of their insurance contracts to determine whether to update the cash flow assumptions more frequently.

The Board believes this requirement would provide a current view of expected future cash flows that would give financial statement users more decision-useful information about an insurance entity's current obligations.

The FASB decided to require a retrospective approach to determining the effect of updating cash flow assumptions. An entity would calculate a revised net premium ratio at contract inception using historical experience and update cash flow assumptions. Additionally, the FASB decided that the:

- Revised net premium ratio would be used to determine the cumulative adjustment recognized in net income;
- Net premium ratio would not be updated for discount rate assumption changes;
- Cash flow assumptions should not include a provision for the risk of adverse deviation;
- Premium deficiency test would not be needed because the cash flow assumptions would be current; and
- Participating contracts would use the net premium reserving model, including an assumption for expected dividend payments.

Discount Rate. At each reporting period, the liability for future policy benefits would be discounted using a current high-quality, fixed-income instrument yield. The difference between the liability for future policy benefits using the original assumption would be recognized immediately in other comprehensive income.

To estimate the discount rate assumption, insurance entities would be required to use reliable information that reflects duration characteristics of the liability for future policy benefits. Additionally, they would need to maximize the use of observable inputs and minimize the use of unobservable inputs. The interest accretion rate would continue to be the original discount rate.

The Board believes that the proper rate for discounting the liability would be a market-based interest rate rather than one linked to an entity's investment experience. The FASB said high-quality interest rates that approximate a risk-free rate plus a liquidity adjustment are sufficiently available, and U.S. GAAP requires those rates to be used to discount pension obligations.[3]

[3] FASB ASC Topic 715, Compensation-Retirement Benefits, available at www.fasb.org.

Market-Risk Benefits

Market-risk benefits would be measured at fair value, and any change in the fair value attributable to a change in the instrument-specific credit risk would be recognized in other comprehensive income rather than earnings. This requirement would apply to contract benefits that meet two criteria:

- The ***contract holder*** has the ability to direct funds to one or more separate account investment alternatives, 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 that exposes the entity to other-than-nominal capital-market risk.

Contracts with market-risk benefits include features such as guaranteed minimum death benefits, accumulation, income, withdrawal, and withdrawal-for-life benefits.

The FASB's decision to require the change in fair value attributable to changes in instrument-specific credit risk to be recognized in other comprehensive income is consistent with its recent decision about the presentation of changes in fair value for liabilities when the fair value option is elected.[4] Because all market-risk benefits would follow this proposed guidance, insurance entities no longer would evaluate whether these market-risk benefits would be derivatives.

Deferred Acquisition Costs

The FASB proposed simplifying the accounting model for deferred acquisition costs by amortizing the costs over the expected term of the related contract:

- In proportion to the amount of insurance in-force over the expected term of the related contract; or
- Straight-line when the amount of insurance in-force cannot be reasonably estimated over the expected term of the related contract (e.g., certain universal or investment contracts).

The amortization pattern for deferred acquisition costs would be updated for actual experience. Deferred sales inducements would be amortized using the same methodology and assumptions that were used to amortize deferred acquisition costs.

The Board believes that simplifying the estimate of the amortization pattern and making it independent of the liability measurement would improve understandability of an insurance entity's financial results. The change would require fewer resources because complex amortization models would not be required. The types of acquisition costs eligible for deferral would not be affected.

[4] FASB ASC Topic 825, Financial Instruments, available at www.fasb.org.

The proposed ASU would eliminate certain concepts from the accounting for deferred acquisition costs:

- Accruing interest on the unamortized deferred acquisition costs balance because they are not a monetary asset and do not use a present value technique;
- Adjusting deferred acquisition costs for the effect of investment performance (shadow deferred acquisition costs) or changes in expected future liability cash flows to reduce the complexity and enhance the understandability of amortization; and
- Performing an impairment analysis on deferred acquisition costs.

Disclosures

The FASB decided to require certain disclosures in interim and annual financial statements.

Future Policy Benefits	Policyholder Account Balances[1]	Market-Risk Benefits [2]
Disaggregated tabular rollforward of the beginning balance to the…		
Ending balance with separate presentation of expected future net premiums and benefits	Ending balance	Ending balance disaggregated by type of market-risk benefit
Each disaggregated rollforward should include the…		
• Undiscounted ending balance for the expected future net premiums and benefits • Gross premiums recognized • Reinsurance receivable • Weighted-average duration of the liability • Qualitative and quantitative information used to measure the liability[3]	• Weighted-average earned rate and the weighted-average crediting rate • Guaranteed benefit amounts in excess of current account balances • Cash surrender value	• Guaranteed benefit amounts in excess of current account balances • Qualitative and quantitative information used to measure the asset or liability[3]

Future Policy Benefits	Policyholder Account Balances[1]	Market-Risk Benefits [2]
Reconciliation of disaggregated rollforwards to the aggregate ending carrying amount…		
Of the liability, and the total interest and gross premiums recognized in the period	Of the liability	Disaggregated between asset and liability positions
Qualitative and quantitative information about…		
• Adverse development at the level of aggregation that reserves are calculated that resulted in a charge to current-period benefit expense due to: – Net premiums exceeding gross premiums in the current period; and – Establishing an additional liability for a universal life contract or investment contract in the current period • The significant inputs, judgments, and assumptions used to conclude that no losses for annuitization benefits or death and other insurance benefits are expected for any contract where the entity did not recognize a liability	• Objectives, policies, and processes for managing risks, including hedging activities	• Objectives, policies, and processes for managing risks arising from market-risk benefits

[1] Additional disclosure requirements include a tabular presentation of policyholders' account balances by range of guaranteed minimum crediting rates, and the related range of differences between rates being credited to policyholders, and the respective guaranteed minimums.

[2] The carrying amount of market-risk benefits should be presented as a separate line item in the statement of financial position. The change in fair value (excluding the portion attributable to changes in instrument-specific credit risk) should be presented as a separate line item in the statement of operations.

[3] Information would vary depending on the account balance, but generally should include significant inputs, judgments, and assumptions used in measuring the liability; changes in those inputs, judgments, and assumptions; and the effect of those changes on the account balance.

Deferred Acquisition Costs and Sales Inducements	Separate Account Assets and Liabilities
Disaggregated tabular rollforward of the beginning balance to the…	
Ending balance, with qualitative and quantitative information about the inputs, judgments, and assumptions used to determine amortization amounts	Ending balance
Disaggregated rollforward should…	
Be consistent with the disaggregation of the liability	Include the related cash surrender values, and a reconciliation to the aggregated carrying amount of the liability
Additional disclosures should include the…	
• Nature of the acquisition costs capitalized; and • Method for amortizing the deferred costs only for sales inducement assets	• General nature of the contracts reported in separate accounts; • Basis for presentation for separate account assets and liabilities and the related activity; • Aggregate fair value of assets, by major investment category, supporting separate accounts as of each date for which a statement of financial position is presented; and • Amounts of gains and losses recognized on assets transferred to separate accounts for the periods presented

When deciding the level of aggregation necessary for disclosures, entities should consider including sufficient detail to allow financial statement users to understand the amount, timing, and uncertainty of cash flows arising from contracts issued by insurance entities. The FASB decided to specify a principle for providing disaggregated information to enable entities to apply judgment in determining the level of disaggregation that is meaningful for their businesses and financial statement users.

Effective Date

The FASB will set an effective date after it reviews comments, which are due December 15.

Transition Requirements

Liability for Future Policy Benefits

- The ASU would be applied retrospectively, using actual historical information; a cumulative catch-up would be recognized in opening retained earnings. However, if that is impracticable, the guidance would be applied to in-force contracts based on their existing carrying amounts at the transition date and future assumptions would be updated
- The cumulative effect of changes in discount rates would be recognized in accumulated other comprehensive income

Market-Risk Benefits

- The difference between fair value and carrying value at the transition date, excluding changes in instrument-specific credit risk, would be recognized in opening retained earnings
- The cumulative effect of changes in instrument-specific credit risk would be recognized in accumulated other comprehensive income

Deferred Acquisition Costs

- The guidance on amortizing deferred acquisition costs would be applied as of the transition date to the existing carrying amount at that date, which would be adjusted to remove amounts included in other comprehensive income, such as shadow deferred acquisition costs
- The same transition method would be applied to other balances, such as sales inducement assets, which are amortized consistent with the amortization of deferred acquisition costs

Disclosures During the Year of Adoption

- Information required for a change in accounting principle, but on a disaggregated basis consistent with recurring disclosure disaggregation[5]
- If retrospective application is impracticable, the portion of the liability not subject to retrospective application
- Qualitative and quantitative information about transition adjustments related to net premiums that exceed gross premiums; and establishing an additional liability for a universal life-type or investment contract

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Jennifer D. Austin, Alan W. Goad, and Brett L. Endler

Earlier editions are available at: kpmg.com/us/frn

[5] FASB ASC paragraphs 250-10-50-1 to 50-3, available at www.fasb.org.