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To the Point

FASB – final guidance

FASB changes how insurers measure and disclose liabilities for long-duration insurance contracts

Insurers will need to change their processes, systems and internal controls to apply the guidance.

What you need to know

- The FASB issued final guidance that will significantly change how insurers account for long-duration contracts, including how they measure, recognize and make disclosures about insurance liabilities and deferred acquisition costs.
- Insurers will be required to review cash flow assumptions at least annually and update them if necessary. They also will have to make quarterly updates to the discount rate assumptions they use to measure the liability for future policyholder benefits.
- The guidance creates a new category of market risk benefits (i.e., features that protect the contract holder from capital market risk and expose the insurer to that risk) that insurers will have to measure at fair value.
- The guidance is effective for fiscal years beginning after 15 December 2020 and interim periods therein (i.e., the first quarter of 2021 for calendar-year insurers) for PBEs and a year later for other entities. Early adoption is permitted. The guidance is to be applied as of the earliest period presented in the financial statements (e.g., 1 January 2019 for calendar-year PBEs).

Overview

The Financial Accounting Standards Board (FASB or Board) issued new guidance[1] that will change how insurers account for long-duration contracts. The changes are intended to provide users of financial statements with more information about insurance liabilities, including the amount, timing and uncertainty of an insurer's cash flows related to long-duration contracts.

Building a better working world

Insurers will have to review and update, if necessary, the assumptions they use to measure insurance liabilities periodically, rather than retain the assumptions made at contract inception over the contract's life, which can extend for several decades over multiple economic cycles. The guidance also will change how insurers recognize and measure deferred acquisition costs (DAC) and require embedded guarantees that meet the definition of market risk benefits to be measured at fair value. In addition, insurers will be required to make new disclosures.

For participating contracts, the guidance for measuring the liability for future policyholder benefits is unchanged.

The new guidance completes the Board's long-standing insurance project. In May 2015, the Board issued final guidance that requires insurers to make additional disclosures about their short-duration contracts.

Key considerations

Liability for future policyholder benefits for traditional long-duration and limited payment contracts

The new guidance will retain the net premium ratio model but require insurers to review their cash flow assumptions (e.g., mortality, morbidity, terminations) at least annually in the same period each year or more frequently if there is evidence that the assumptions should be revised. Insurers will be able to make an entity-wide election to not update expense assumptions.

This is a significant change from today's guidance, which requires insurers to base their liability for future policyholder benefits in traditional long-duration contracts and limited-payment contracts on assumptions that are locked in at contract inception, unless the portfolio is determined to be in a loss position.

Under the new guidance, insurers will calculate a revised net premium ratio to reflect their actual experience since contract inception and their updated future cash flow assumptions. This revised ratio will be applied as of the beginning of the period in which the updates occur, and a cumulative catch-up adjustment based on the difference between the carrying value of the liability at the beginning of the reporting period and the liability measured as of that date using the revised net premium ratio will be reported separately as a component of total benefit expense in net income as a "remeasurement gain or loss" in the period. The revised ratio will be applied for the remaining life of the contract, unless it is updated in subsequent periods. Any change in the liability after the beginning of the reporting period will be reported in the current period's income statement as a component of benefit expense.

If the present value of future expected benefits and expenses exceeds the present value of future gross premiums, the insurer should cap the net premium ratio at 100% and recognize a loss in the income statement (and a corresponding increase in the liability) in the period. In addition, the guidance will prohibit insurers from recognizing an asset when the present value of future net premiums exceeds future expected benefits and expenses for a contract group. Insurers will be allowed to group contracts issued in the same year, but they will not be able to group contracts from different issue years. For contracts they acquired, insurers must use the acquisition date as the contract issuance date.

Insurers will determine the rate they use to discount the liability for future policyholder benefits by using assumptions based on estimates of the upper-medium-grade (low credit risk) fixed-income instrument yield (generally interpreted as an A rating) that maximize the use of observable inputs, rather than using the expected investment yield approach. Insurers will have to update their discount rate assumptions every quarter and recognize the effect of changes in the discount rate in other comprehensive income (OCI). The interest accretion rate recognized in income will be the discount rate at contract inception determined in accordance with the new guidance.

Market risk benefits

The guidance will create a new category of benefit features called market risk benefits that will provide protection to the contract holder from capital market risk and expose the insurer to other-than-nominal capital market risk. Protection refers to the transfer of a loss in, or shortfall of, the contract holder's account balance from the holder to the insurance entity, but this does not include protection of the contractual death benefit component of a life insurance contract.

Insurers will measure market risk benefits at fair value and present them separately in the statement of financial position. Changes in the fair value will be recognized separately in net income, except for changes in fair value attributable to a change in the instrument-specific credit risk, which will be recorded as a separate component of OCI.

Under existing guidance, certain features that will meet the definition of market risk benefits are accounted for as either embedded derivatives or insurance liabilities in accordance with the benefit ratio model. Insurers will continue to apply existing guidance for features that are not deemed market risk benefits.

The guidance will create a new category of benefit features called market risk benefits that insurers will have to measure at fair value.

Deferred acquisition costs

Insurers will have to amortize DAC (and other balances that refer to the DAC model, such as deferred sales inducement costs and unearned revenue liabilities) for long-duration contracts on a constant-level basis (i.e., constant relative to the value of insurance in force) over the expected life of the contract. Insurers must use assumptions that are consistent with those used to measure the liability for future policyholder benefits. Insurers may amortize DAC at the individual contract level or at the unit of account established for the related liability. In either case, the pattern should approximate straight-line amortization and should not be based on revenue or profits.

If actual experience exceeds expected experience (e.g., contract terminations exceed expectations), a proportionate amount of DAC should be expensed in the period. If any assumptions change, insurers must recognize the effect over the remaining expected life of the contracts.

The guidance will apply to all long-duration contracts, including participating contracts and universal life-type contracts but not to certain investment contracts accounted for under Accounting Standards Codification (ASC) 944. The following components of the existing DAC model will no longer be required: interest accretion; impairment analysis; and adjustment for the effect of unrealized gains and losses on available-for-sale securities.

Disclosures

The guidance will significantly expand the disclosures insurers make about long-duration contracts in their annual and interim financial statements. They will have to make additional disaggregated disclosures for the insurance liabilities and DAC, including rollforwards of opening and closing balances and quantitative and qualitative information about significant inputs, judgments and assumptions used in the measurement of the liabilities and DAC. The new guidance establishes a principle for determining how to disaggregate the new disclosures to provide meaningful information to users of financial statements.

Effective date and transition

The guidance is effective for public business entities (PBEs) for fiscal years beginning after 15 December 2020 and interim reporting periods therein. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021 and interim periods within fiscal years beginning a year later. Early adoption is permitted.

Insurers will apply the guidance on measuring the liability for future policyholder benefits on a modified retrospective basis as of the earliest period presented in the year of adoption. Under this method, the opening balance at the transition date would generally be the same as the closing balance before transition, updated for the removal of any related amounts previously recorded in accumulated other comprehensive income (AOCI) (e.g., shadow loss reserves) and updated for changes in the discount rate.

The cumulative effect of changes in discount rates between the rates applied in the measurement of the liability immediately before the transition date and the upper-medium-grade fixed-income instrument yield at the transition date will be recorded in AOCI. An insurer will be allowed to apply a full retrospective transition approach by issue year only if actual historical information is available for all contracts issued by the insurer that will be affected by the new guidance. Regardless of the transition method elected, all other changes in the liability for future policyholder benefits will be recognized in opening retained earnings.

Insurers will be required to apply the same transition approach for DAC as they use for the guidance on the liability for future policyholder benefits.

Insurers will apply the guidance on measuring market risk benefits on a retrospective basis as of the earliest period presented in the year of adoption. Insurers can use hindsight at transition to determine assumptions to use in the calculation of fair value at the contract inception date if the information relevant for determining the assumptions at contract inception is unobservable or unavailable and cannot be independently substantiated. Changes in fair value attributable to the instrument-specific credit risk between the contract issue date and the transition date will be recognized as a cumulative-effect adjustment in AOCI. All other changes between the fair value and the carrying value immediately before the transition date will be recognized in opening retained earnings.

Endnote:

[1] Accounting Standards Update 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts*.