FASB Targeted Improvements

Presenters

Thomas Q Chamberlain ASA, MAAA   Russ Menze, FSA, MAAA
Deloitte Consulting

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Contents: FASB TI: Long Duration Summary, Interpretations, Operation and Impact

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FASB Targeted Improvements

Guidance Summary

FASB TI: Guidance Summary - Timeline

IASB and FASB Joint Project

In October 2008, FASB and IASB agreed to a joint project to address:

- recognition,
- measurement,
- presentation and
- disclosure

for insurance contracts.

FASB Proposed ASU

In June 2013, FASB leaves the joint project to focus on targeted improvements for existing US GAAP guidance with a proposed ASU (Topic 834) open for industry feedback.

FASB Proposed ASU

In September 2016, FASB issues proposed ASU Financial Services - Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts.

FASB Proposed ASU

In April 2017, FASB holds a public roundtable meeting on Topic 944

In August 2017, FASB proposes tentative decisions based on public feedback.

Final ASU targeted for 2018.

2008 | 2013 | 2016 | 2017-18 | 2020-21

FASB TI: Assumptions

- Assumptions
  - Discount Rate
    - Re-establish the discount rate used in calculating Benefit Reserves
    - There are two discount rates
      - At issue locked-in Discount Rate
      - Updated at each measurement date Discount Rate
    - Discount Rate defined as "…a current upper-medium grade (low credit risk) fixed-income instrument yield."
      - "An insurance entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs…"
      - "…with durations similar to the liability for future policy benefits."
  - Note the how the connection with the Company portfolio is removed as Investment Yields is changed to Discount Rate
    - The beginning of the break down of the matching principle
  - When developing the discount rate, all tenors may be considered and frequency
  - The duration matching or "similar" requirement will need some clarification

FASB TI: Assumptions

- Assumptions
  - Remove Provisions for Adverse Deviation (“PAD”)
  - Previously locked-in actuarial assumptions are no longer locked in
    - Assumption unlocking will occur at least once a year, at the same time every year
    - based on company experience or more frequently if evidence suggests the unlock is necessary
  - Expenses assumptions should be updated but an insurance entity may elect not to update the expense assumption

- <u>*“update…by considering actual historical cash flows and the updated expected future cash…”*</u> (only when determining Benefit Reserves)
  - Some consider this modification to the assumption used to the historical periods
  - Some consider this an indication that the method of the calculations changes from seriatim to an issue year or more granular cohort
  - “…contracts issued within a single issue year may be grouped when determining the level of aggregation for liability measurement.”
    - Across issue years are prohibited

FASB TI: Long Duration Benefit Reserves

- Benefit Reserves (FAS 60)
  - Net Level Premium Reserve
    - Net Level Premium Percent determined at issue (NLP%)
    - Discount Rate defined as "...a current upper-medium grade (low credit risk) fixed-income instrument yield." at issue
  - With the cohort component specifically identified in the guidance, a decision on the approach will be necessary
    - Seriatim
    - Cohort (Annual, Semi-Annual, Quarterly, Monthly)
  - NLP% Cap
    - NLP% is capped at 100% or alternatively, the Benefit Reserve cannot be less than zero
  - There will be two benefit reserve calculations (at least)
    - NLP Discount Rate (to determine the NLP% and operating income)
    - Updated Discount Rate (to determine the NLP%)
  - Assumptions are unlocked

FASB TI: Long Duration Deferred Acquisition Cost

- Deferred Acquisition Costs (FAS 60, FAS 97, FAS 120)
  - No Discount Rate, no interest on DAC
  - The basis of amortization based on the run off of face amount or linear if not readily determinable
  - Deferrals are not to be recognized until incurred

- The amortization is no longer aligned with the definition of revenue, a further break down of the matching principle

- This leads to a non-level amortization amounts until the final deferral amount is realized
  - Board Decision called for "...a principle in which deferred acquisition costs would be amortized on a constant basis over the expected life of the contract."
  - This lends itself to a pivot type method for the amortization update

- Assumptions are unlocked

FASB TI: Market Benefit Risk

- Market Benefit Risks
  - Balances should be reported at fair value
    - But are these types of contracts technically an embedded derivative?
  - Benefits generated by guarantees supported by underlying separate account investment options where investment risk, net of fees, are passed through to the policyholder and there is more than nominal capital market risk (equity, interest rate, and foreign exchange)
    - Originally intending to capture VA guarantees
  - Measure market risk benefits at fair value and the portion attributable to "own credit" is recognized in other comprehensive income ("OCI")
    - What about the own credit portion for existing embedded derivatives?
  - Recent Board Decisions decided to include general account products with these types of riders such as fixed index annuities

FASB TI: Transition & Disclosure

- Transition
  - Benefit Reserves and DAC
    - An insurance entity would have the <u>option to apply the proposed amendments retrospectively</u>
    - The same transition method is used for both future policy benefits and deferred acquisition costs.
  - Market Risk Benefits
    - Apply the proposed amendments to market risk benefits <u>retrospectively</u> to all prior periods.
      - An insurance entity would be allowed to use hindsight.

- Disclosures
  - Disclosures include a significant level of disaggregation of balances in a roll forward format
    - Account balances, future policyholder benefits, DAC, separate account liabilities, and market risk benefits
  - Disclose quantitative and qualitative information and changes in such information used as significant inputs, judgments, and assumptions in the measurement

What do these words have in common?

What consumers wanted…

- Betamax
- Humvee
- Green Lantern Movie

What consumers really wanted…

- VHS
- Prius
- Captain America Movie

We will have to wait an see…

FASB Targeted Improvements

New Business Examples

FASB Targeted Improvements for Long Duration Products

ASC 944 (Previously known as “FASB 60”)

Non-Par Whole Life Product: Comparison of a New Issue under HGAAP and TGAAP

Product

- Issue Age: 45
- Gender: Male
- Face Amount: 1,000,000
- Annual Gross Premium: 18,000
- Acquisition Cost: 100/ policy
- Commission Structure: 80%, 30%, 10%, 10, 10, 10, 10, 5%, 5, 5....
- Premium Tax: 11.50%
- Maintenance Expense: $35/policy

Assumptions

- Starting Cohort: 1,000 lives
- Investment Yield: 3.54%
- Valuation Rate PAD: -25 bps
- Lapse Rates: 12%, 11%, 9,9,9,7,7,7…
- Mortality: 2001 CSO
- Mortality PAD: 10%

TGAAP Assumptions

- *Discount Rate: 3.50%
- No PADs

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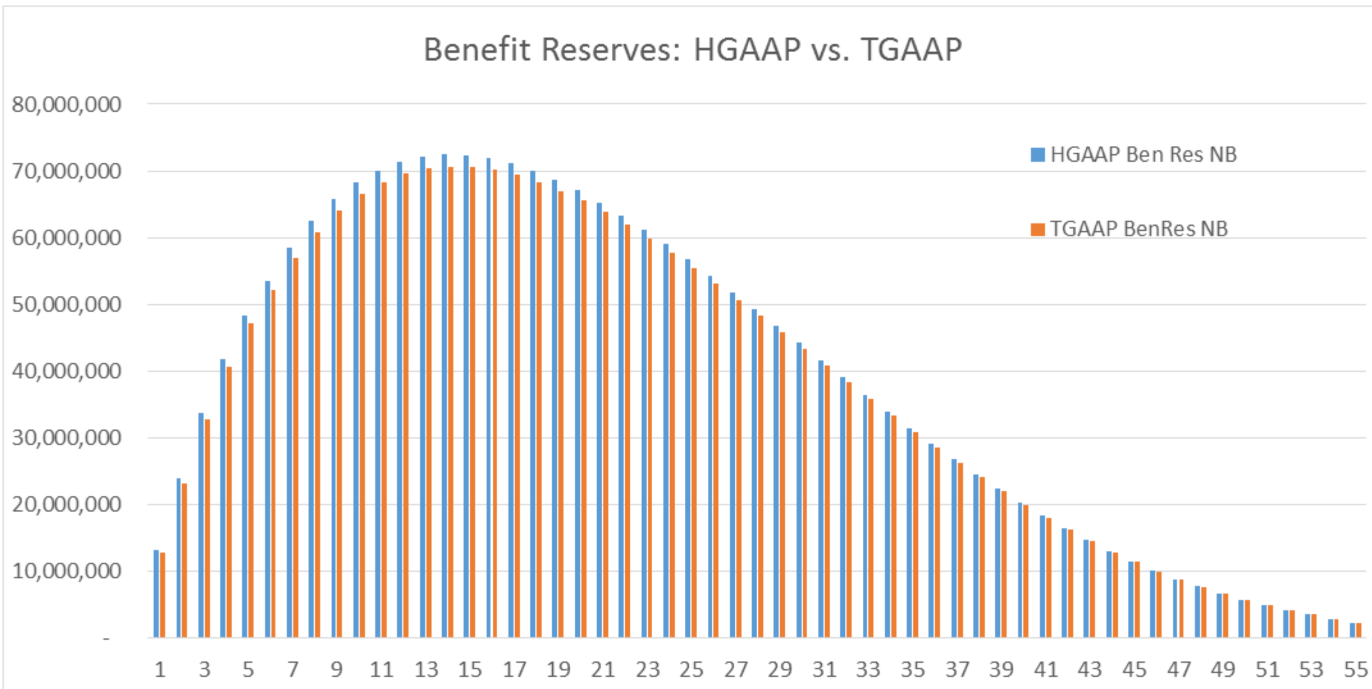
New Business Traditional Life Examples

HGAAP New Business vs TGAAP New Business: No Transition

Benefit Reserves for HGAAP and TGAAP differ due to the following components:

- PADS: HGAAP has 10% mortality PAD and -25 bps discount rate PAD.
- Discount Rate: HGAAP uses a portfolio based discount rate less a PAD (3.54% before PAD). TGAAP uses a single equivalent yield determined from the high quality investment vehicle* yield curve (AA, 3.36%) discount rate.



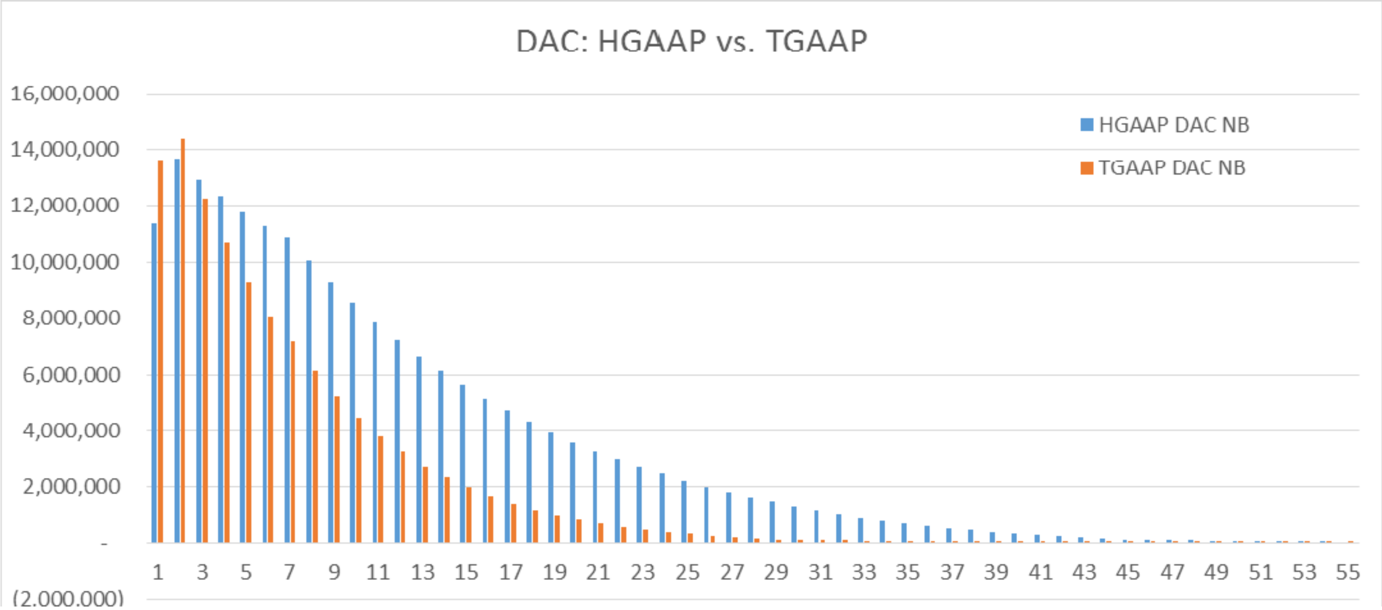
*Note that this example used a high quality investment vehicle. This was not updated for FASB comments dated early October 2017. The results are valid as originally modeled.

New Business Traditional Life Examples

HGAAP New Business vs TGAAP New Business: No Transition

DAC for HGAAP and TGAAP differ due to the following components:

- PADS: HGAAP has 10% mortality PAD and -25 bps discount rate PAD.
- Discount Rate: HGAAP uses a portfolio based discount rate. TGAAP uses no discount rate.
- Basis for Amortization: The HGAAP basis for amortization is the present value of gross premium. TGAAP is the sum of expected face amount.
- Method for Amortization: TGAAP uses a pivot method that increases the rate of amortization each year to reflect new amounts capitalized when incurred. HGAAP uses a constant rate that incorporates all future expected deferrals in the amortization rate.

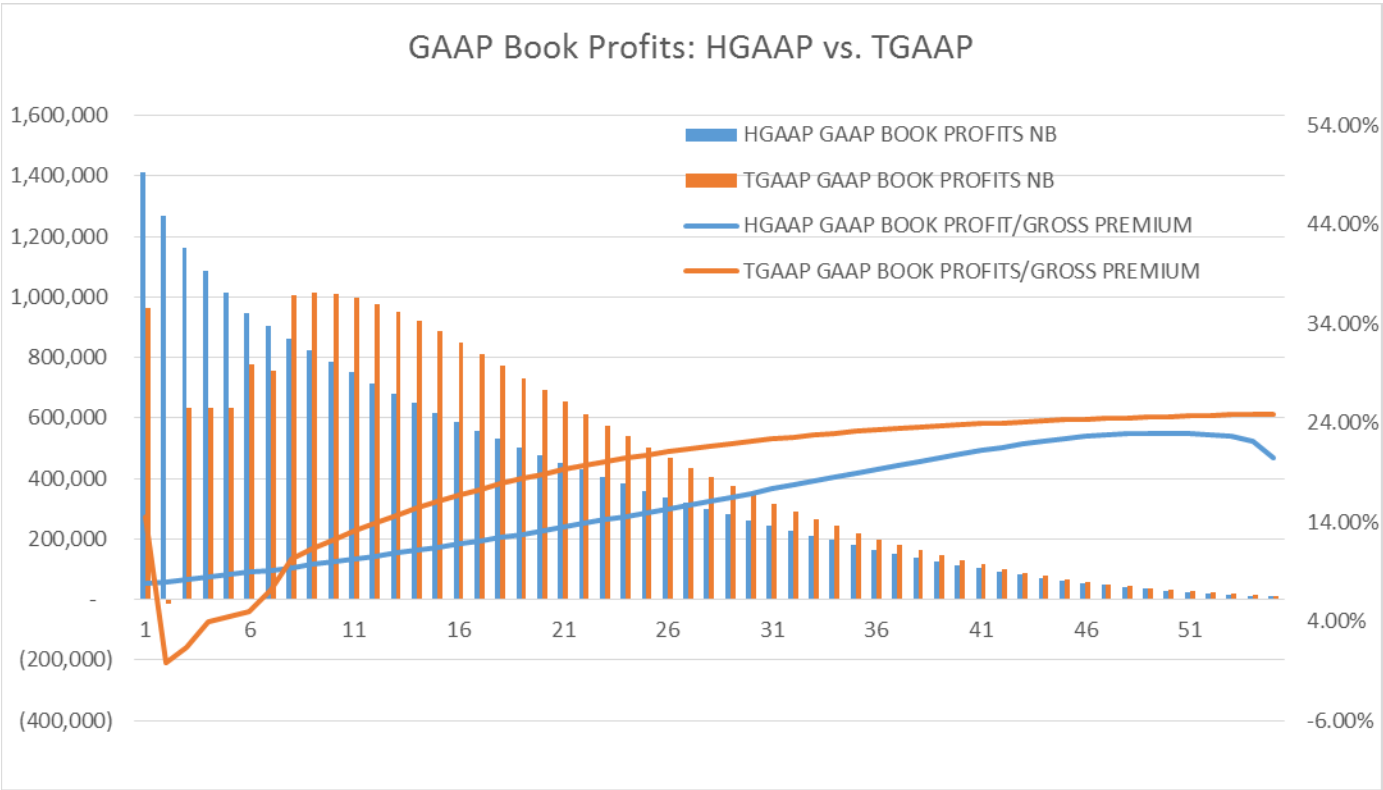


New Business Traditional Life Examples

HGAAP New Business vs TGAAP New Business: No Transition

GAAP Book Profits for HGAAP and TGAAP differ due to the following components:

- GAAP Book Profits ("GBP") excludes interest on surplus. Under HGAAP, the GBP declines with the population and gross premiums. Under TGAAP GBP are pushed to the center of the lifetime with a pattern more like a benefit reserve.



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FASB Targeted Improvements for Long Duration Products

ASC 944 (Previously known as “FASB 60”)

Single Premium immediate Annuity Product: Comparison of a New Issue under HGAAP and TGAAP

Product

- Issue Age: 80
- Gender: Female
- Monthly Benefit: 305/Monthly for Life
- Single Premium: 40,000
- Acquisition Cost: $2,000

HGAAP Assumptions

- Starting Cohort: 1,000 lives
- Investment Yield: 3.54%
- Valuation Rate PAD: -25 bps
- Mortality: 1983 IAM
- Mortality PAD: 0%

TGAAP Assumptions

- *Discount Rate: 2.26%
- No PADs

*Note that this example used a high quality investment vehicle. This was not updated for FASB comments dated early October 2017. The results are valid as originally modeled.

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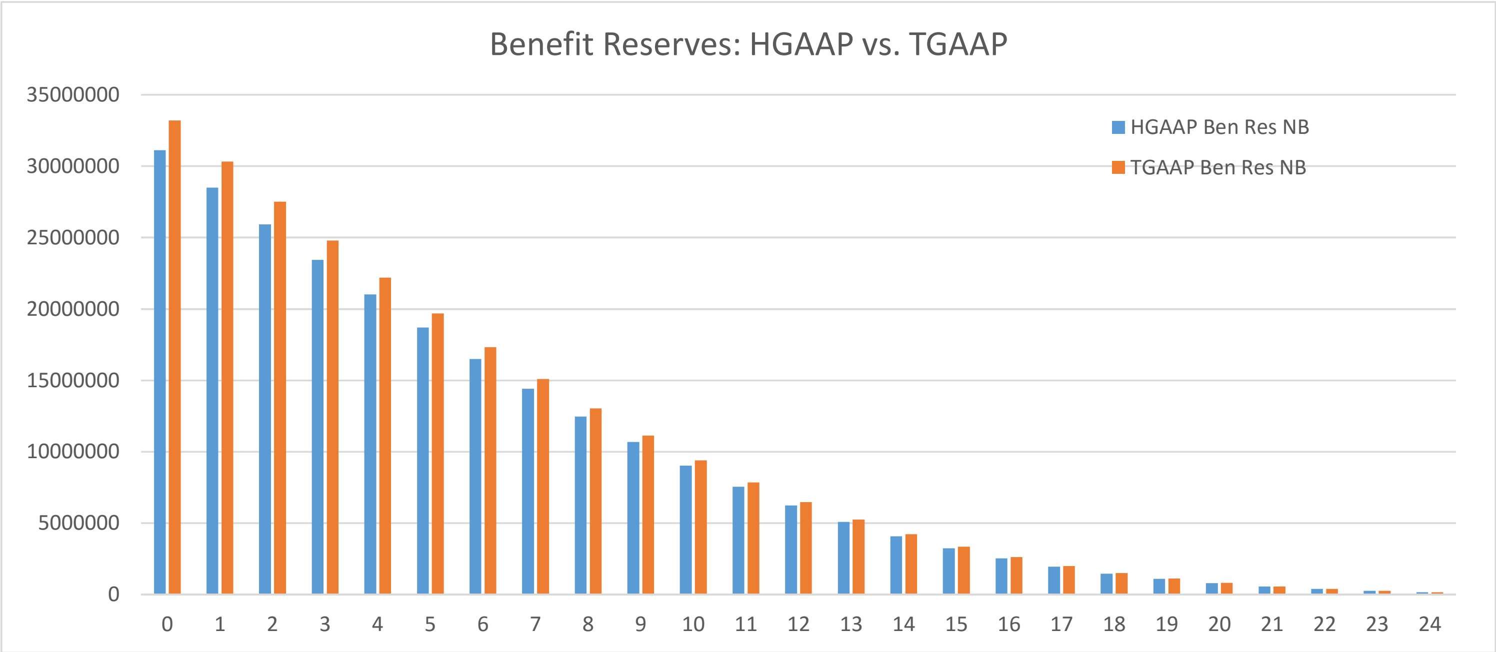
New Business SPIA Examples

HGAAP New Business vs TGAAP New Business: No Transition

Benefit Reserves for HGAAP and TGAAP differ due to the following components:

- PADS: HGAAP has -25 bps discount rate PAD.
- Discount Rate: HGAAP uses a portfolio based discount rate less a PAD (3.54% before PAD). TGAAP uses a single equivalent yield determined from the investment vehicle yield curve* (AA, 2.26%) discount rate.



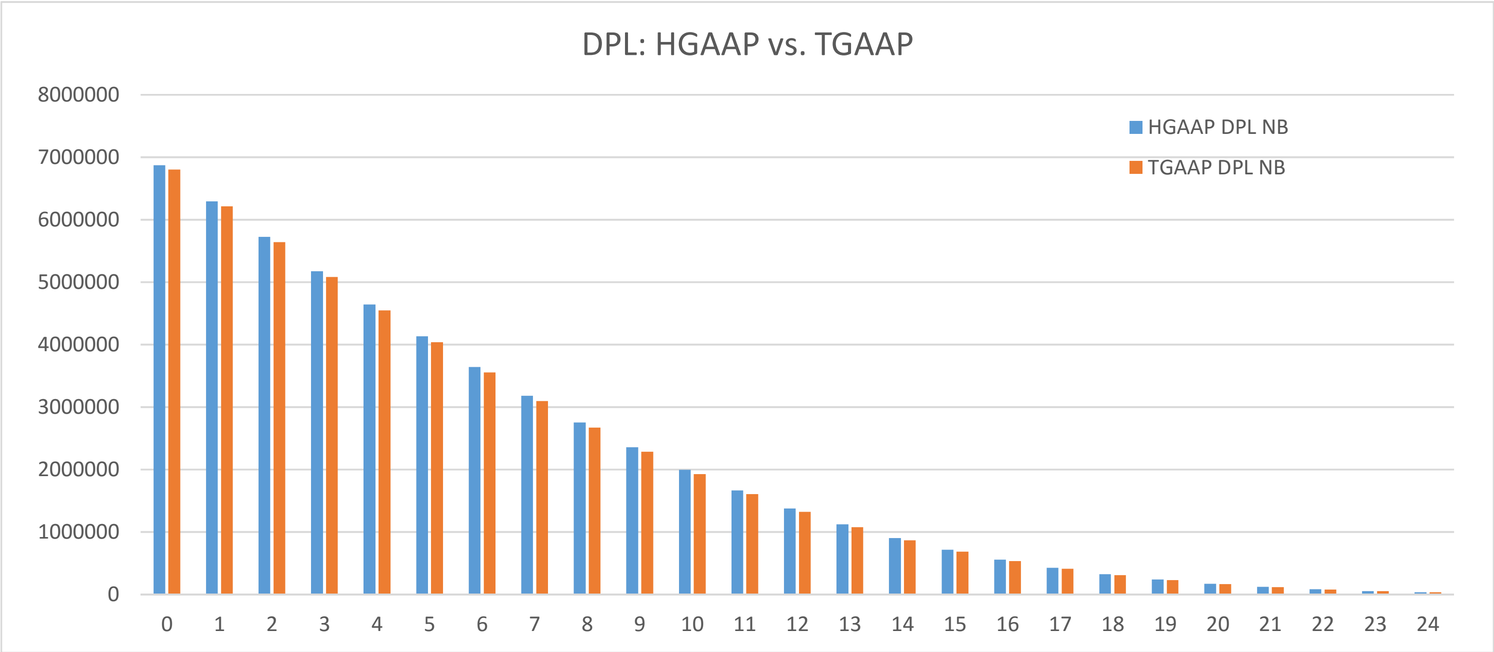
*Note that this example used a high quality investment vehicle. This was not updated for FASB comments dated early October 2017. The results are valid as originally modeled.

New Business SPIA Examples

HGAAP New Business vs TGAAP New Business: No Transition

Deferred Profit Liability for HGAAP and TGAAP differ slightly due to the following components:

- PADS: HGAAP has -25 bps discount rate PAD.
- Discount Rate: HGAAP uses a portfolio based discount rate less a PAD (3.54% before PAD). TGAAP uses a single equivalent yield determined from the investment vehicle yield* curve (AA, 2.26%) discount rate.



*Note that this example used a high quality investment vehicle. This was not updated for FASB comments dated early October 2017. The results are valid as originally modeled.

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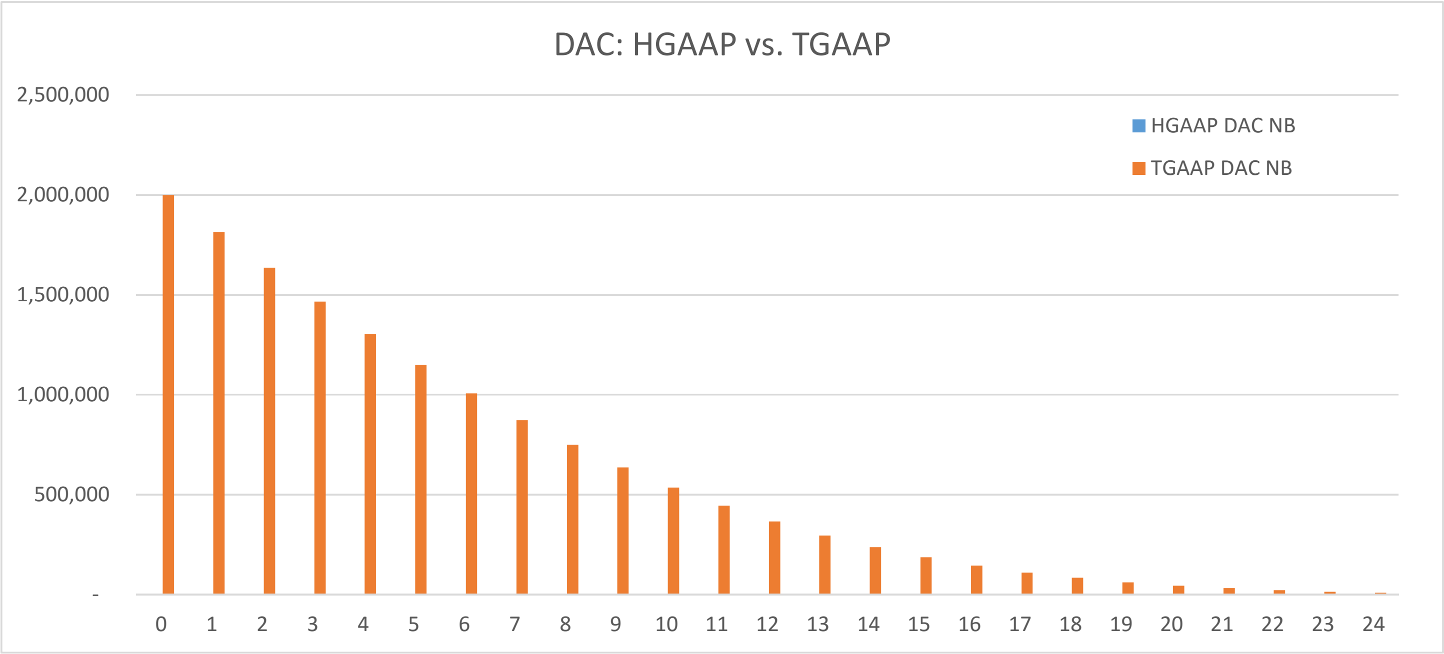
New Business SPIA Examples

HGAAP New Business vs TGAAP New Business: No Transition

DAC for HGAAP and TGAAP differ due to the following components:

- PADS: HGAAP has -25 bps discount rate PAD.
- Basis for Amortization: The HGAAP basis for amortization is the gross premium. TGAAP is the sum of expected benefits. The removal of the matching principle is evident here.
- Method for Amortization: TGAAP uses a run-off method over the sum of expected benefits.



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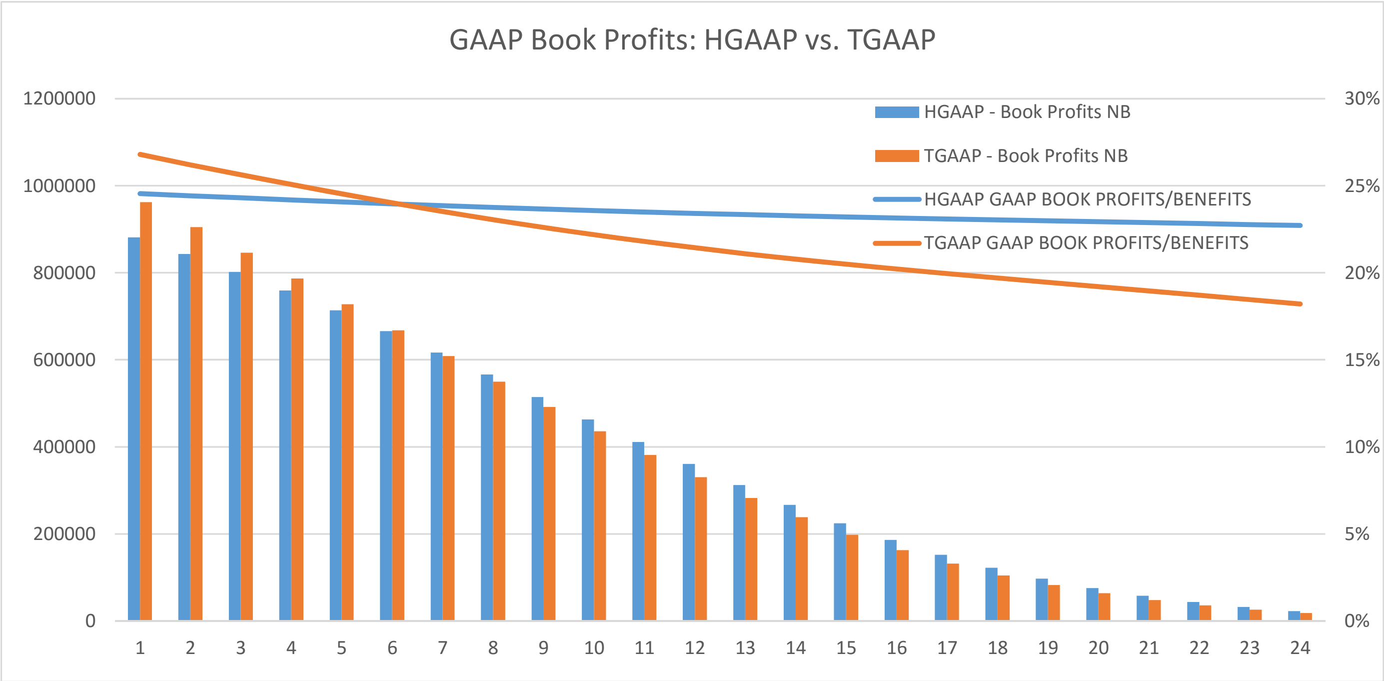
New Business SPIA Examples

HGAAP New Business vs TGAAP New Business: No Transition

GAAP Book Profits for HGAAP and TGAAP differ due to the following components:

- GAAP Book Profits ("GBP") excludes interest on surplus. Under HGAAP, the GBP declines slightly with the population. The Under TGAAP GBP are higher earlier but lower in the future. This is due to the amortization of DAC. The DPL balances are close but the offsetting DAC amortization under TGAAP pulls down the future GBP. The implicit margin is also larger for TGAAP which makes earnings steeper despite the same PV (GBP).



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FASB Targeted Improvements

Operational Considerations

FASB Targeted Improvements for Long Duration Products

ASC 944 (Previously known as “FASB 60”)

Operational Considerations

- Assumptions
  - A significant amount of historical data will need to be collected and analyzed in order to establish a best estimate and reflect historical cash flows
    - Some existing processes may be leveraged (loss recognition testing) to mine historical best estimates
    - IT resources may be needed in order to manage all of the historical data
  - Accounting/Actuarial policies will need to be established/modified/created for the assumption setting
    - Aggregation (revise), Reserve Granularity (revise), Shadow Balances (revise), Assumption Setting (revise), Negative AGP Treatment (delete)
  - The “historical cash flow” requirement may need some interpretation in order to implement

FASB Targeted Improvements for Long Duration Products

ASC 944 (Previously known as “FASB 60”)

Operational Considerations

- Discount Rate
  - Discount Rates at issue are locked in
    - Yield curve/single equivalent yield development decision
    - Optimizing market observable data to be addressed for longer duration products
- Actuarial Methods
  - Interpretations and analysis is required to inform and align the Finance Department and develop data requirements (IT and Investments)
- Valuation System Updates/Upgrades
    - Unlocking Assumptions, one locked-in Discount Rate
    - Revised DAC functionality
    - Updated NLP% and multiple Benefit Reserve calculations

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FASB Targeted Improvements for Long Duration Products

ASC 944 (Previously known as “FASB 60”)

Operational Considerations

- Reporting
  - Internal
    - GAAP book profits will grow in a new pattern that will need to be reflected in any planning process
    - DAC and Benefit Reserve roll forward reports and analysis (reserves per 1,000) will require refinements
    - New ledger entries for FAS 60 will be required
    - Support for Internal Audit and/or Model Validation groups
    - Management Source of Earnings Reports
  - External
    - Rating Agencies
    - Disclosures
    - External Auditors