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FASB US GAAP Long Duration Targeted Improvements ASU-2018-12

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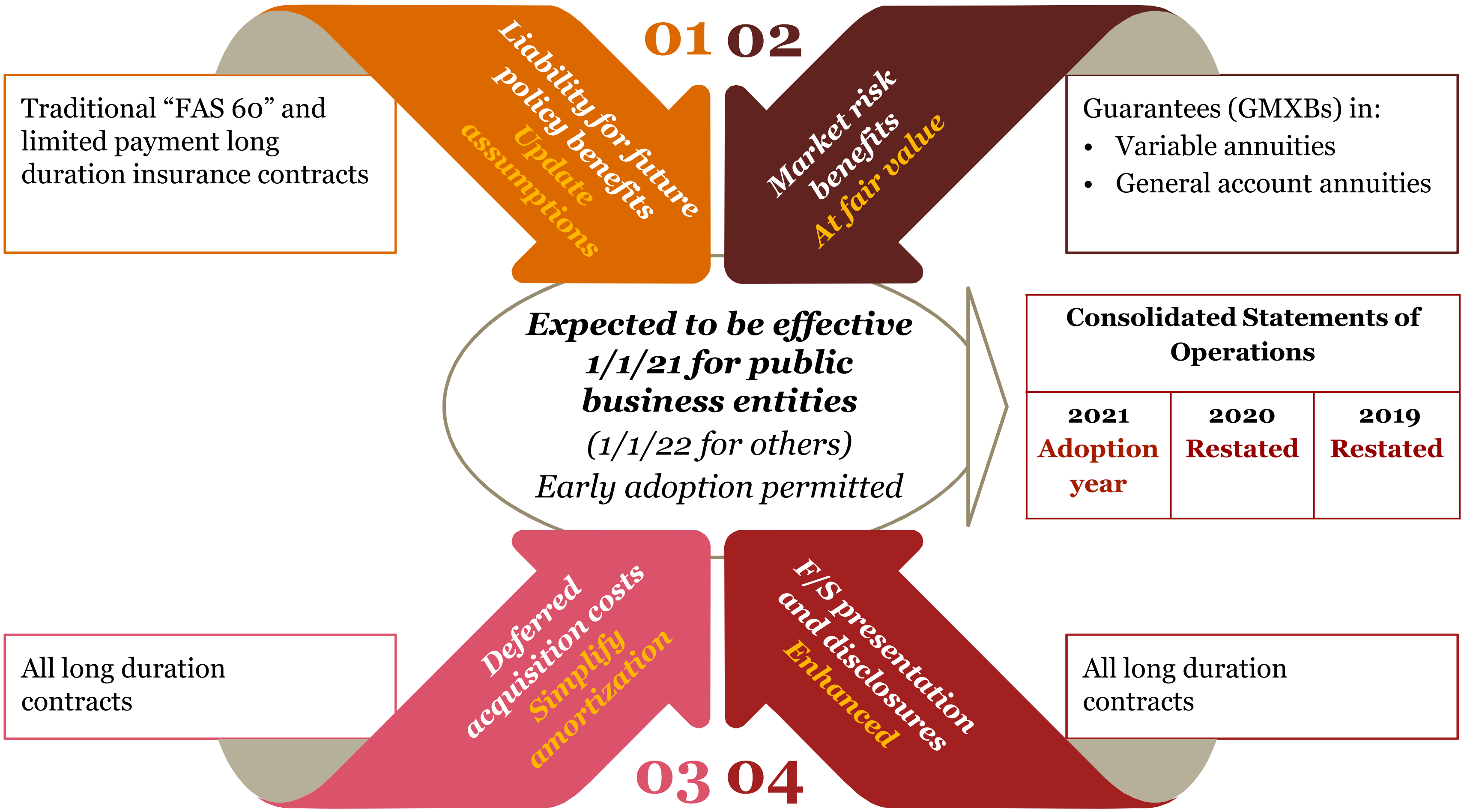
Agenda

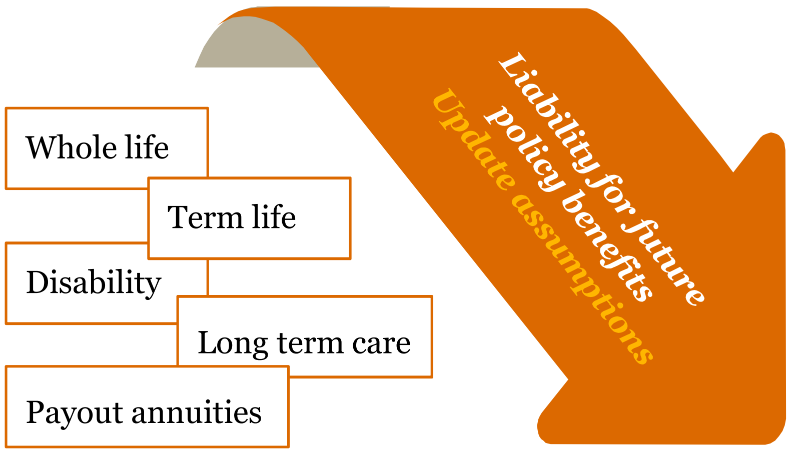
- Overview of Standard
- Illustrative Impact Example for Term policy
- Considerations and Challenges for Implementation
- Questions

Overview of the Standard

FASB Long-duration targeted improvements – Overview of Changes



FASB Long-duration targeted improvements – Liability for future policy benefits



**Participating contracts are excluded*

Measurement assumptions

- Assumptions must be reviewed/updated at least annually on retrospective basis (but updating other expenses is policy choice)
- No more PAD
- Premium deficiency test replaced with net premium ratio capped at 100%
- Annual cohort limitation: contracts from different original issue years cannot be grouped

Discount rate assumptions

- Upper-medium grade (low credit risk) fixed-income instrument yield (single "A")
- Discount rate updated at each reporting date through OCI

Transition

- "Modified retrospective" transition approach
  - Pivoting off of the balance at transition

$$\frac{\text{PV future benefits - existing 1/1/19 liability}}{\text{PV future gross premiums}}$$

= revised net premium ratio for 2019

  - Discount rate NOT reset for purposes of calculating future net premiums and interest accretion at transition
  - Same annual cohort limitation applies
- Option to elect a "full retrospective" transition approach if necessary criteria are met

FASB Long-duration targeted improvements - Market risk benefits (MRBs)

Measurement

- Fair value with changes through income
- Except that changes to instrument-specific credit risk recognized in OCI

Presentation

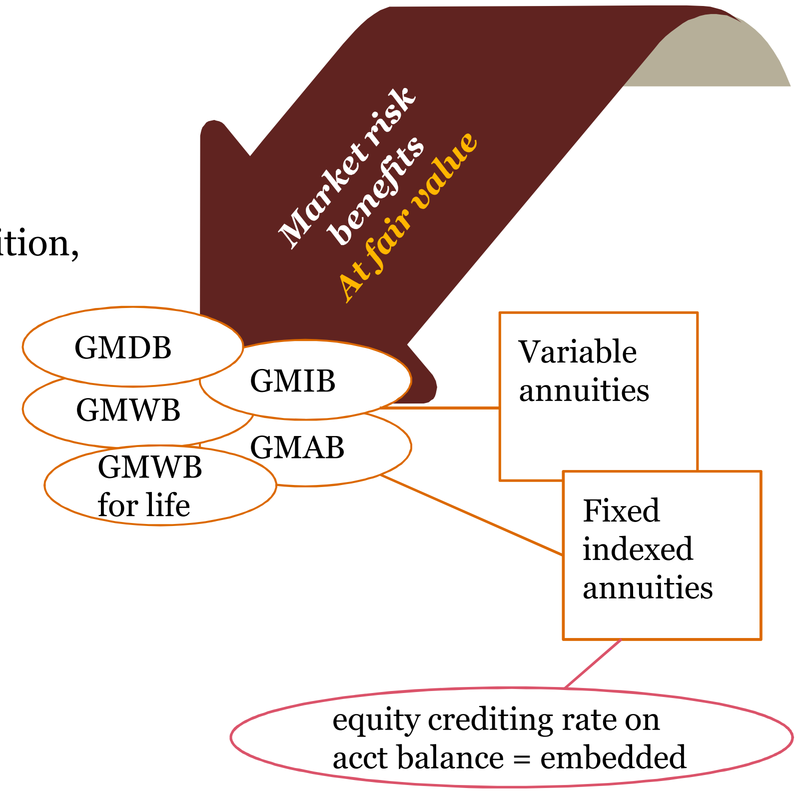
- Separate presentation in statement of financial position, statement of operations and statement of OCI

IN Scope

- All types of GMXBs:
  - In variable annuity separate accounts
  - In general account annuities
- Annuitization interest rate guarantees if other than nominal

OUT of Scope

- Minimum interest rate guarantees on account balance
- Variable life insurance benefits
- No lapse guarantees on universal life

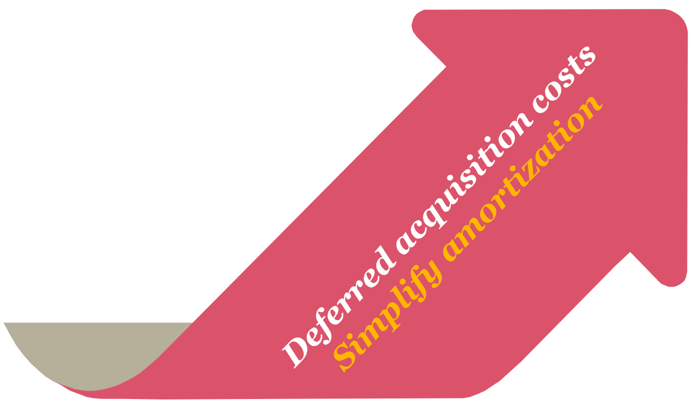


Transition

- **Retrospective application:** *If assumptions in prior period unobservable or otherwise unavailable and cannot be independently substantiated (e.g., to calculate "attributed fee" at contract inception), may use hindsight in determining assumptions*

FASB Long-duration targeted improvements – DAC amortization

Year	Insurance in force	Amortization
2021	$1,000	16
2022	1,000	16
2023	1,000	16
2024	1,000	16
2025	1,000	16
Total	5,000	
DAC	80	80
Amortization rate	1.6%	



Scope

- All long-duration insurance contracts (except investment contracts that use effective yield method)

DAC amortization

- Principles-based amortization: constant level basis over expected life of contract, independent of profit emergence
- No impairment test
- No interest accretion
- Accrue and amortize acquisition costs only as incurred
- Assumption changes affect prospective amortization

What about other balances similar to DAC ?

- Deferred sales inducement costs and U/L unearned revenue liability
- Other balances often amortized like DAC (business combination intangibles and cost of reinsurance)?

Transition

- Apply new amortization method to existing DAC balances at transition date (after removing shadow DAC adjustment from AOCI)
- Except where full retrospective method adopted for liability for future policy benefits.

FASB Long-duration targeted improvements - Presentation and disclosure

Presentation requirements

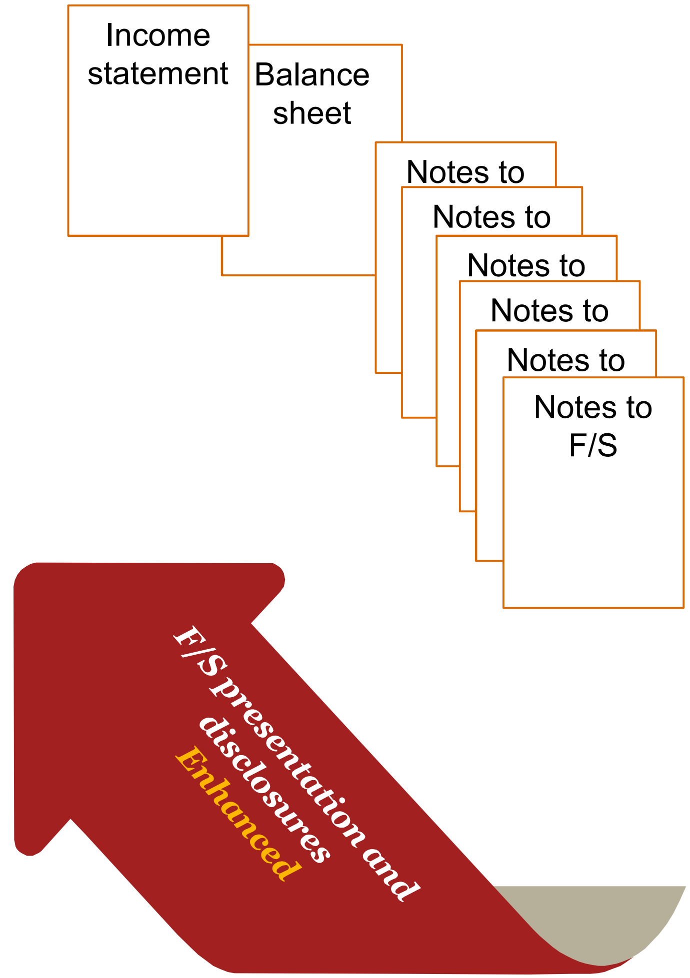
- Impact of updating assumptions for liability for future policy benefits separately presented in P/L
- MRB separately presented in B/S with changes in fair value separately presented in P/L and OCI

Disclosure requirements

- For annual and interim reporting periods:
  - Disaggregated rollforwards and reconciliations to B/S amounts
- For annual reporting periods and as required under ASC 270 for interim reporting:
  - Information about inputs, judgments, assumptions and methods, changes during the period, and effect of those changes
  - Qualitative and quantitative discussion about adverse development
  - Premium deficiency methodology utilized and the liability recorded for participating insurance contracts (including closed block) and U/L contracts

Transition

- Disaggregated rollforwards of pre-adoption transition date balances to post-adoption transition date balances
- Qualitative and quantitative information about the effect of transition adjustments



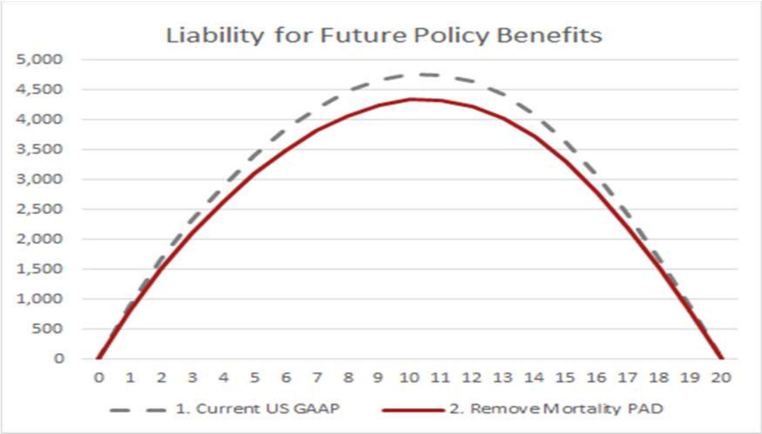
Illustrative Impact Example for Term Policy

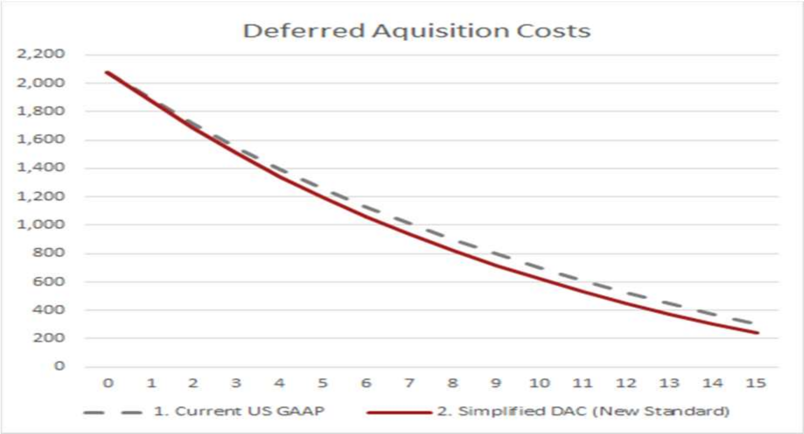
Illustrations - Term life

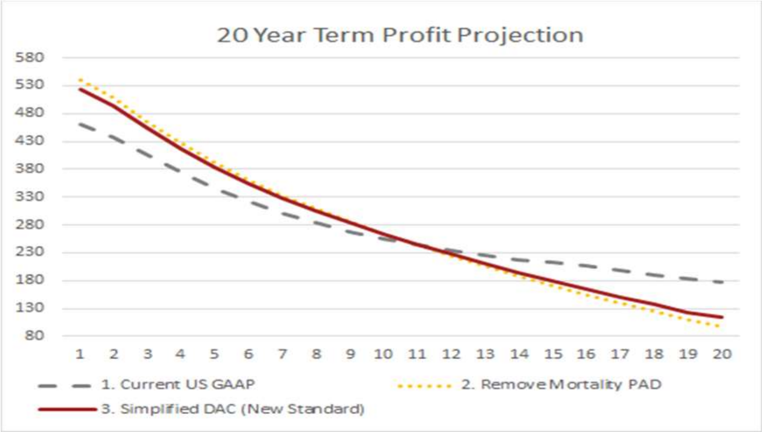
- The following slides provide illustrations of the potential changes for a 20 year term life insurance policy
- Illustrations of the ASU 2018-12 changes on policy benefit liabilities and DAC vs. current US GAAP are provided for the following circumstances:
  - Experience variances (lapses)
  - Actuarial assumption changes (mortality)
  - Discount rate changes (reduction)
- Some simplifying assumptions are made to enhance the transparency of results. E.g., deferrable acquisition costs are assumed at inception of the contract, level discount rates, and 100% shock lapse at end of the level premium term
- Liability for future benefits and deferred acquisition cost balances are projected on a cohort basis (i.e., historical cash flows from terminated policies are included in the net-premium ratio retrospective unlocking, and projected inforce amounts are aggregated for DAC amortization purposes)

Term life – Baseline

Current vs. New US GAAP Standard







Observations

Baseline scenario uses a 10% mortality PAD and a 5% level discount rate. The new standard uses best estimate assumptions without PAD. Both use a level 5% discount rate.

Liability for future policy benefits

- The removal of the mortality PAD produces lower reserves under the new standard

Deferred acquisition cost

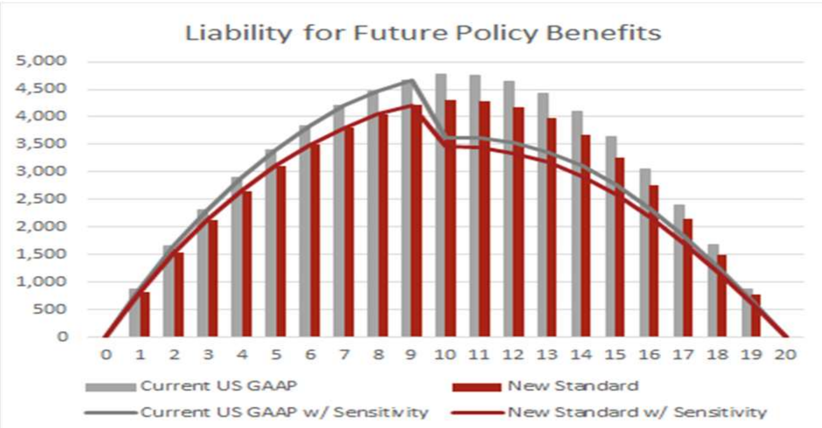
- Current approach – amortization in proportion to premiums.
- New standard – amortization based on projected in-force amounts.
- The new standard accelerates DAC amortization since there is no interest accretion.

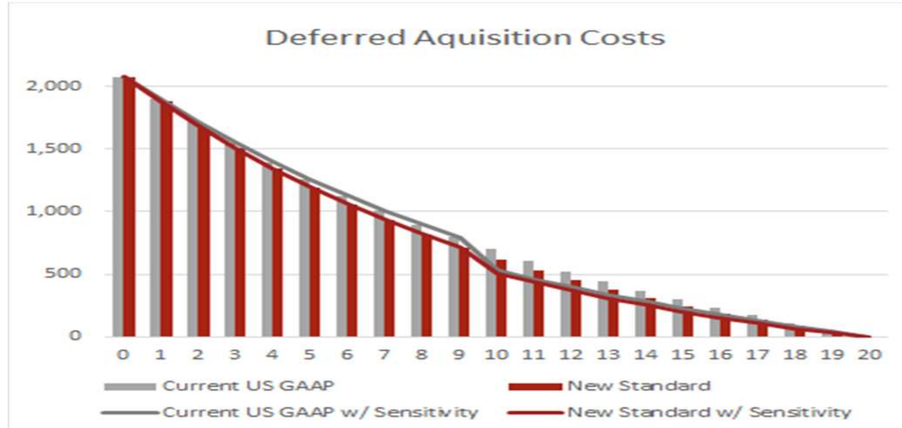
Pre-tax Income

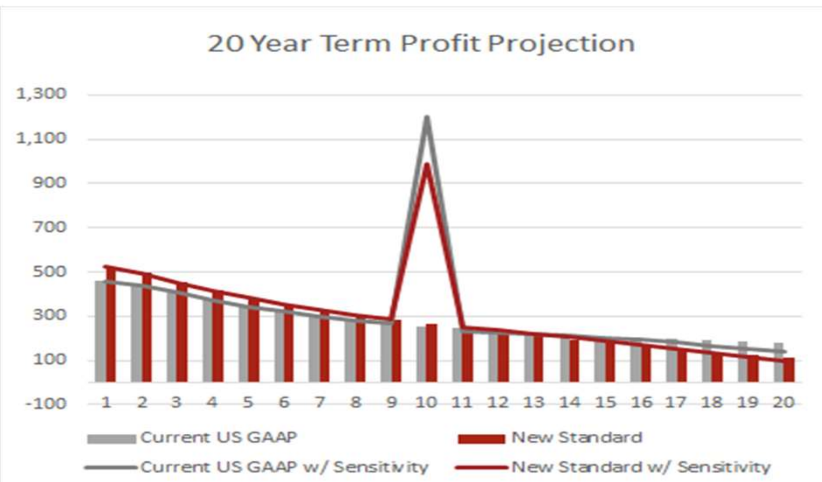
- Under the baseline scenario, profit emergence is accelerated under the new standard mainly due to lower benefit reserves due to the removal of PADs.

Term Life – Lapse experience deviation

Current vs. New US GAAP Standard







Observations

Assumed that 30% of business lapses in year 10. No change to prospective cash flow assumptions.

Liability for future policy benefits

For both approaches, the liability reflects additional terminations in year 10. For the new standard, the liability reduction is less than current GAAP due to having no PADs and because of the retrospective unlocking (i.e., net premium ratio decreases as less benefit claims were paid due to the additional terminations)

Deferred acquisition cost

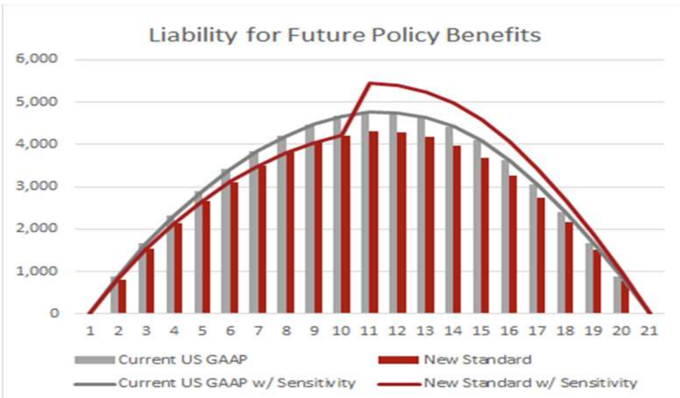
For both approaches, the DAC balance reflects additional terminations. However, the amortization pattern remains unchanged as there is no change to prospective cash flow assumptions.

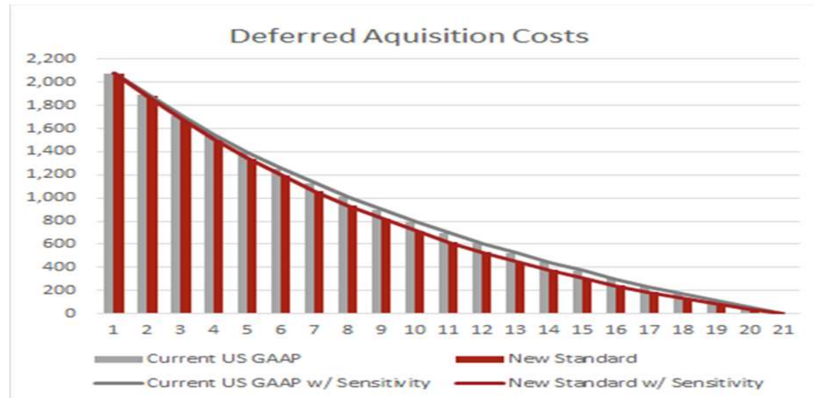
Pre-tax Income

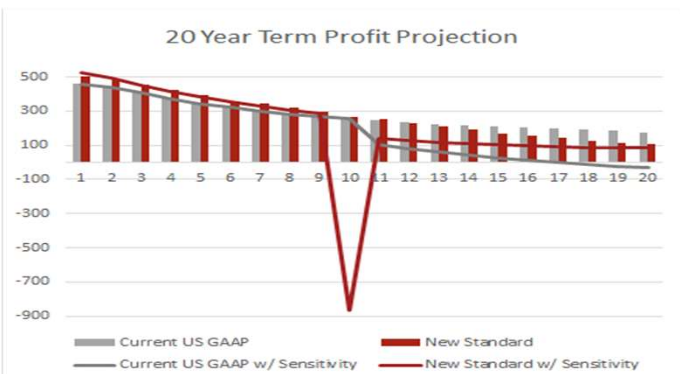
A gain in year 10 is observed due to the release of the net GAAP liability. The new standard delays profit emergence due to the retrospective unlocking.

Term Life – Prospective mortality update

Current vs. New US GAAP Standard







Observations

Assumed a 20% increase in mortality in year 10 and future years. Experience emerges as expected in prior years (i.e., no current period impacts)

Liability for future policy benefits.

- Assumptions under the current approach are locked-in, small impact is observed due to the reduction in in-force. The new standard reflects the assumption update in year 10, but the liability increase is partially offset by the retrospective unlocking (i.e., the net premium ratio increases anticipating the 20% increase in future benefit claims)

Deferred acquisition cost

- Both approaches reflect the projected reduction in in-force, but the observed DAC impact is relatively small. The prospective DAC amortization pattern is revised in the new standard only due to the assumption update

Pre-tax Income

- Under the current approach, projected profits decrease as claim payments increase. The new standard produces a loss in year 10 due to the reserve increase, but profit emergence is smoother in future years.

Considerations and Challenges for Implementation

Strategic implications

1

Earnings volatility and risk sensitivity

Changes in the liability measurement from retrospective unlocking and fair value measurement of market risk benefits will impact the volatility of earnings

2

Transition opportunities

Different transition approaches are possible for inforce policies depending on information available. The approach adopted will impact future earnings recognition and associated KPIs.

3

Increased disclosures

Additional disclosure requirements are on a disaggregated basis with more granular reconciliations needed to be provided. The increased transparency will impact communication to investors and analysts.

4

Budgeting and strategic planning

Management information used for budgeting and strategic planning will need to consider both current state and future state impacts. A strategy for moving to future state metrics during transition will need to be developed.

5

Product decisions

Differences in the accounting measurement of insurance products and their profitability will impact product design and decisions. For example, some products may be regarded as introducing more earnings volatility which may or may not be within acceptable tolerance limits.

6

Hedging

Changes in the liability measurement - particularly for contracts with market risk benefit - may require redesign of existing ALM and hedging strategies subject to firms risk appetite and capital optimization frameworks.

7

Annual incentive plans

Annual incentive KPIs will need to be reviewed given the impact of the change in measurement approach. Educating executives on potential changes in behavior from revised metrics will need to be carefully managed.

8

Tax strategy & planning

The tax strategy is likely to need to be reviewed in light of actions that firms take to optimize the new measurement framework and that have that have consequential tax implications.

Technical challenges

1

Assumption updates

Annual (or more frequent) updating of cash flow assumptions for liability for future policy benefits using retrospective method. A more robust process for tracking experience and setting assumptions will likely need to be developed.

2

Discount rates

Liability-based discount rate based on upper-medium (low credit risk) vs. "expected investment yield" used today. Decisions will be required on whether to use a full curve vs single rate. Discount rates will be updated on a quarterly update (i.e. at each reporting date) and require a new process to allow changes to go through OCI.

3

DAC calculation

Simplified DAC amortization:
- Constant basis over the life of the contract
- No interest accretion and no impairment test

This change will require model changes and new templates for DAC reporting (e.g. DAC roll-forwards).

4

Transition

Various transition approaches are possible which creates additional complexity and complicates market communication of impacts at transition date.

5

Fair value market risk benefits

GMxBs with capital market risk at fair value (excluding traditional universal-life and variable life products); "instrument-specific credit risk" adjustment through OCI. A more granular attribution analysis will be required to categorize impacts to appropriate buckets.

6

Disclosure

Detailed disaggregated roll forwards of liabilities and DAC; qualitative and quantitative information about estimates. Significant enhancements is needed to data, systems and processes to comply with the new disclosure requirements.

Business operation challenges

1

Capturing new and additional data points

New reporting/presentation requirements require additional data points to be captured. For example, the requirement for disaggregated roll-forwards of future policy benefits will require data gathering at a more granular level. These may already be available from existing policy admin system feeds (but not currently used for reporting) or may need additional data captured at the source level.

2

Actuarial valuation and reporting infrastructure

New systems capabilities will be needed for:

- New level of aggregation (e.g., issue year cohorts) for measurement
- Incorporation of assumption updates to production - better capabilities to monitor A/E and controls over experience studies
- Capping of net-premium ratio at 100%
- Recalculation of net-premium ratio with cumulative catch up through net income
- Calculation of liabilities under multiple discount rates
- Update of net-premium ratio (above) using locked-in discount rates
- New DAC calculation and amortization basis.
- Market inputs for fair value calculation
- New or different mapping of financial information to financial statements (e.g., OCI)

3

New financial reporting controls

The new accounting requirements will require new data points and data flows/processes which are not subject to management's existing data and process controls. Need incremental controls over systems, business processes and financial reporting.

4

Financial reporting infrastructure

The new accounting requirements include new and different mapping of financial information to financial statement lines and significantly more extensive disclosure requirements. Increased automation and changes to the financial close process needed to maintain the financial close timeline.

5

Historic data points needed for transition

Historic data needed to calculate transition amounts for in-force policies may not be easily accessible or may not have been captured at all. Once determined, transition amounts have to be separately tracked and reported from new business after transition.

Implementation and transition challenges

1

Finance, actuarial and IT resources

The transition effort will require significant finance, actuarial, PMO and IT resources that will need to be sourced from internal reallocations, new hires and external assistance.

2

PMO and interactions to in-flight projects

Other projects being carried out for finance, actuarial, risk, capital or IT may compete for resources or have conflicting requirements which need to be managed. Ideally these projects should be aligned and ultimately converge in order to best leverage the investment made.

3

Parallel reporting during 2020

Parallel reporting will be needed to capture information under the new requirements on a timely basis during 2020, but presents logistical challenges for IT, actuarial and finance resources to be able to prepare financial reporting under both bases of accounting. This is an aggressive timeframe with a short implementation period.

4

Board and Executive Team training

Board and the Executive Team will need to be educated on the new requirements, including the policy development, business and operational issues that needs to be addressed and determine the impacts on strategic goals and actions for the company.

5

Management of external communications

Changes to accounting requirements will impact the financial statement information that is used by external stakeholders. Investors and analysts will expect a clear story on the impacts to the business model and comparison against historic performance.

6

Coordination across jurisdictions

The standard will require global implementation for insurers with international operations. How best to engage and coordinate across territories needs to be carefully considered and managed.

Questions?

Thank you!