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New Accounting for Long-Duration Contracts Issued by Insurers and Reinsurers

A discussion of ASU 2018-12

Moderator:



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Overview of the Key Targeted Improvements

ASU 2018-12

Key “Targeted Improvements” ...

No.	Area of Focus	Current		Future
1.	Liability for future policy benefits (FPBs)	This reserve represents a portion of policyholder premium set aside to cover future policy benefits and expenses for traditional long-duration products with fixed and guaranteed benefits	At issuance, future <u>conservative</u> cash flow assumptions “ <u>locked-in</u> ” and tested in the aggregate thereafter to ensure the overall reserve remains adequate. Discount rate is the insurer’s <u>expected investment yield</u>	Future <u>best estimate</u> cash flow assumptions <u>updated</u> at least <u>annually</u> Discount rate that reflects the characteristics of <u>liability</u> (risk free rate plus a liquidity premium) and <u>updated</u> each <u>reporting period</u> .
2.	Measurement of market risk benefits	Reserve for policyholder guarantees that involve capital market risk	<u>Two</u> very different measurement <u>models</u> exist for guarantees with capital market risk: (a) fair value (b) insurance “accrual” model.	<u>One</u> measurement model (<u>fair value</u>) for most guarantees with significant capital market risk.
3.	Amortization of Deferred Acquisition Costs (DAC)	Amortization of commissions and other costs allowed to be deferred and amortized to income over time.	Current methods are <u>complex</u> and difficult to understand	<u>Simplified</u> amortization method for <u>all</u> products
4.	Presentation and Disclosures		<u>Limited</u> disclosures regarding long-duration insurance products	Significantly <u>enhanced and disaggregated disclosures</u> for all long-duration products

Future Policy Benefit Reserves

Relevance, Representative Faithfulness, and Verifiability

Key Products Impacted	Current GAAP	Targeted Improvements	Transition
<ul style="list-style-type: none"> • Whole Life* • Term Life • Disability • Long Term Care • Payout annuities <p>* Excludes Participating Contracts in the U.S.</p>	<p>Reserving approach focuses on:</p> <ul style="list-style-type: none"> • Locked-in assumptions at issue • Provision for adverse deviation (PAD) • Annual loss recognition testing with all product issue years combined 	<p><u>Cash flow assumptions</u></p> <ul style="list-style-type: none"> • Reviewed/updated at least annually on retrospective basis (through income statement) • Best Estimate - No PAD • Portion of annual gross premiums set aside to cover future benefits and expenses (a.k.a. net premium ratio) capped at 100% • Annual cohort limitation – can’t combine contracts issue in different years in calculating the 100% cap <p><u>Discount rate assumption</u></p> <ul style="list-style-type: none"> • Updated each reporting period directly through stockholders’ equity (OCI) • Upper-medium grade fixed income yield (single “A”) - de-linked from the expected yield on the underlying investments 	<ul style="list-style-type: none"> • “Modified retrospective” <ul style="list-style-type: none"> - Pivot off the balance at transition - “Lock-in” discount rate NOT reset at transition - Same annual cohort limitation • Update discount rate <ul style="list-style-type: none"> - “locked-in” rate vs current single “A” rate - Impact on AOCI at transition

Panel Discussion.....

Market Risk Benefits

Timeliness and Comparability

Key Products Impacted	Current GAAP	Targeted Improvements	Transition
<ul style="list-style-type: none"> • Variable Annuities (VA's) • Other Non-traditional Annuities • Other products 	<ul style="list-style-type: none"> • Insurance "accrual" model for certain guarantees that contain significant insurance risk (e.g. GMDBs on VA's) • Fair value model for certain guarantees that meet the definition of an embedded derivative (e.g. GMABs on VA's) • Some companies actual have a single guarantee with the accounting split between the above two models. 	<ul style="list-style-type: none"> • Fair value through income statement • FV changes due to instrument specific credit risk (a.k.a. "own credit") directly to stockholders' equity, through OCI • Scope: <ul style="list-style-type: none"> - All GMxBs, certain annuitization guarantees, and other guarantees • Excluded: <ul style="list-style-type: none"> - No-lapse guarantees on UL and VUL products - Variable life insurance benefits - Minimum interest guarantees on non-traditional life and annuity contracts 	<ul style="list-style-type: none"> • "Modified retrospective" <ul style="list-style-type: none"> - Full retrospective adoption back to contract issuance - May use "hindsight" in limited circumstances - Difference between FV and previously recorded reserve is an adjustment to retained earnings and AOCI ("own credit" portion) at the transition date

Panel Discussion.....

Deferred Acquisition Cost Amortization

Understandability and Representative Faithfulness

Key Products Impacted	Current GAAP	Targeted Improvements	Transition
<ul style="list-style-type: none"> All long-duration contracts, except certain investment contracts with no significant source of earnings other than investment spread. 	<ul style="list-style-type: none"> Rules-based: Amortization depends on income recognition by type of contract <ul style="list-style-type: none"> - Traditional products: premiums (no unlocking) - Variable Annuities and Universal life: estimated gross profits (subject to retrospective unlocking) - Participating whole life: estimated gross margins (subject to retrospective unlocking) 	<ul style="list-style-type: none"> Principles-based: Constant level basis over life of contracts <ul style="list-style-type: none"> - "delink" with revenue or profit emergence - No impairment test - No interest accretion - Accrue & amortize only as incurred 	<ul style="list-style-type: none"> Prospective <ul style="list-style-type: none"> - Removal of "shadow" balances - New amortization method applied to current balance (excl. shadow) at transition date

Panel Discussion.....

Presentation and Disclosure

Understandability and Timeliness

Key Products Impacted	Current GAAP	Targeted Improvements	Transition
<ul style="list-style-type: none">• All long-duration contracts	<ul style="list-style-type: none">• Limited qualitative and quantitative required disclosures today for DAC and related insurance liabilities	<ul style="list-style-type: none">• Significant additional interim and annual quantitative and qualitative disclosures, including insurance asset and liability rollforwards at disaggregated levels for:<ul style="list-style-type: none">• DAC (including balances amortized like DAC)• Liability for Future Policy Benefits• Policyholder Account Balances• Market Risk Benefits• Separate Account Liabilities	<ul style="list-style-type: none">• Disclosures required to “connect” previously reported balances to the “new” balance sheet as of the transition date.

Panel Discussion.....

Liability for Future Policy Benefits

PV of Expected Future Benefits	Dec. 31, 201X	Dec. 31, 201X-1
Balance Beginning of year		
Beginning Balance at original discount rate		
Effect of changes in CF assumptions		
Effect of actual variances from expected experience		
Adjusted beginning of year balance		
Issuances		
Interest accrual		
Benefits paid		
Derecognition (lapses)		
Ending balance at original discount rate		
Effect of changes in discount rate assumptions		
Balance, end of year		

Market Risk Benefits Rollforward

	Dec. 31, 201X	Dec. 31, 201X-1
Balance Beginning of year		
Beginning Balance before effect of changes in instrument-specific credit risk		
Issuances		
Interest accrual		
Attributed fees collected		
Benefit payments		
Effect of changes in interest rates		
Effect of changes in equity markets		
Effect of changes in equity market volatility		
Actual policyholder behavior different from expected		
Effect of changes in PH behaviors assumptions		
Effect of changes in other future expected assumptions		
Balance, end of year before impact of changes in instrument specific credit risk		

QUESTIONS?