FASB Finalizes New Insurance Rules

After almost 10 years of discussions, the Financial Accounting Standards Board (FASB) recently issued Accounting Standards Update (ASU) 2018-12, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts.* This ASU makes targeted—but substantial—changes to financial reporting for companies that issue long-duration contracts such as life insurance and annuities. The new guidance:

- Requires an annual assumptions update for liability measurement
- Standardizes liability discount rate
- Improves measurement of market risk benefits
- Simplifies amortization of deferred acquisition costs (DAC) on a more level basis
- Requires enhanced disclosures, including rollforwards and information about significant assumptions and the effects of changes in those assumptions

These amendments will significantly change current practice, and insurers will need to change how they monitor and gather data. Due to the extensive updates to systems, processes and internal controls required to comply with the new guidance, the ASU is not effective for public business entities (PBE) until 2021.

Effective Dates ASU 2018-12	PBEs	All Others
	Annual and interim reporting periods beginning after December 15, 2020	Annual reporting periods beginning after December 15, 2021, and subsequent interim periods

Assumption Updates

Under current guidance, for traditional long-duration contracts (whole life, term life, annuities in payout status, long-term care and disability income), limited-payment contracts and participating life insurance contracts, assumptions for measuring future policy benefit liabilities—investment return, mortality, morbidity, lapses and expense assumptions—are locked in at policy inception and unlocked or reset only if there is a premium deficiency. This may lead to significant differences between initial and current assumption estimates.

ASU 2018-12 mandates an annual review and—if changes exist—update of all assumptions used to calculate the liability for future policy benefits. The updates would be done at the same time every year, or more frequently if actual experience or other evidence indicates earlier assumptions should be revised. The effect of the change in assumptions on the liability estimate would be recorded in net income.

The changes about updating assumptions only apply to traditional and participating life insurance contracts, which currently follow a "locked-in" accounting model. Regular updates are already required for nontraditional contracts, including universal life and variable annuities.

Discount Rate Update

Discount rate assumptions would be updated quarterly. The net premium ratio is not updated for discount rate changes; rather, the effect of discount rate assumption changes is recorded immediately in other comprehensive income (OCI). The interest accretion rate shall remain the original discount rate used at contract issue date.

These changes will result in a more current measure of the liability based on the current assumptions. The effects of any deterioration would be recorded earlier than under current guidance.

Discount Rate

Insurers currently use an asset rate or investment yield reflecting the interest rate it expects to earn on the assets supporting the policies at contract origination. Under the new guidance, long-duration insurance contract liabilities should be discounted using an upper-medium grade (low credit risk) fixed-income instrument yield.

Market Risk Benefits

A market risk benefit protects a contract holder from capital market risk, *e.g.*, investment losses due to a market correction. These minimum benefit guarantees are embedded in nontraditional contracts and include guaranteed minimum income, accumulation, withdrawal or death benefits commonly offered in variable annuities. Insurers currently use two different models to value these guarantees—some guarantees are fair valued and some follow an insurance model whereby a liability is gradually built up over time. To create consistency, the ASU requires that insurers only use the fair value model, and the portion of a fair value change attributable to a change in an entity's own credit risk should be recognized in OCI.

These amendments do not apply to features that are accounted for as embedded derivatives under Accounting Standards Codification 815, *Derivatives and Hedging*.

Amortization of DAC

DAC, such as sales commissions or underwriting costs, are incurred in connection with acquiring or issuing insurance contracts. Those that directly relate to the successful acquisition of new—or renewal of—insurance contracts are required to be capitalized and recorded as a DAC asset. All other costs are expensed as incurred. Acquisition costs are the same across product types; however, the way those costs get reflected or expensed in the income statement varies by product type, as noted in the table below. ASU 2018-12 makes the expense pattern more easily predictable and no longer fluctuate with an insurance company's investments or underwriting performance.

ASU 2018-12 eliminates the three current methods for amortizing DAC for long-duration contracts and requires insurers to use a "balance of insurance in force" method whereby costs would be expensed evenly over the expected life of a book of contracts. This would be done in proportion to the amount of contracts outstanding. If the amount of insurance in force is variable or unpredictable, *e.g.*, universal life or investment contracts, a straight-line method in proportion to the number of contracts outstanding could be used. Investment contracts will continue to use the effective interest method to amortize DAC costs.

DAC is required to be written off for unexpected contract terminations but is not subject to impairment testing.

Amortization of DAC		
Product	Current Method	ASU 2018-12
Traditional Life	Proportion to Premium	Balance of Insurance in Force
Nontraditional	Estimated Gross Profit	
Participating Life	Estimate Gross Margin	

Disclosure

Extensive new disclosures are required, including disaggregated rollforwards of beginning to ending balances of the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities and DAC. Insurers also must disclose information about significant inputs, judgments, assumptions and methods used in measurement, including changes in those inputs, judgments and assumptions, and the effect of those changes on measurement.

Transition

Changes to the liability for future policy benefits and DAC will apply to all outstanding contracts on the basis of their existing carrying amounts at the beginning of the earliest period presented, adjusted for the removal of any related amounts in accumulated OCI (AOCI). Companies will have the option to apply the changes retrospectively (with a cumulative catch-up adjustment to the opening balance of retained earnings), using actual historical experience information as of contract inception. This option will be elected at the issue-year contract aggregation level and applied to all contract groups for that issue year and all subsequent issue years.

Market risk benefits will be measured at fair value at the beginning of the earliest period presented. A cumulative catch-up adjustment will be recognized in two pieces:

- The cumulative effect of the changes in the insurance entity's credit risk will be recognized in AOCI
- The difference between fair value and carrying value—excluding the effect of credit risk changes—will be recognized in the opening retained earnings

Effective Date

For PBEs, the amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application of the amendments is permitted.

A more comprehensive white paper will be issued shortly. For more information, contact your BKD advisor.

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