

FASB's targeted improvements to long-duration contracts

What it means for GAAP earnings volatility and profit emergence

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With the release of Accounting Standards Update 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts* (ASU 2018-12), senior finance, accounting and actuarial leaders across the industry are taking notice. ASU 2018-12 represents one of the most fundamental updates to life insurance and annuity accounting in 30 years and presents a range of challenges to the preparers of financial statements and their users alike. With the requirement that public business entities adopt ASU 2018-12 in 2021 and with a transition date of January 1, 2019, insurance companies are faced with a significant amount of change in a short time frame.

As with many reporting changes, there is much to think about, from the technical (understanding and explaining new accounting policies and earnings measures) to the practical (modifying data and valuation systems) to the strategic (making decisions on adoption that impact opening equity and future earnings emergence). Yet while some may view ASU 2018-12 as an exercise in accounting compliance with little to gain, others see a potential opportunity to upgrade technology, enhance data management and streamline processes in an effort to obtain fresh insight into businesses presented under accounting frameworks long in need of an update. Finance and accounting organizations must also prepare themselves for greater levels of transparency, as well as increased complexity, in reporting processes.

A change this broad requires engagement and perspectives from multiple stakeholders. Throughout the year, Ernst & Young LLP will be presenting a variety of viewpoints and perspectives across technical, practical and strategic topics.

This paper presents the first of our technical perspectives on earnings emergence.

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One of the key things that companies need to figure out is what information to present and how to present it within the framework of the new guidance. This could influence how users of financial statements will interpret the potential increased volatility and changes in earnings emergence associated with traditional long-duration contracts, limited-payment contracts and market risk benefits. After insurance companies transition to meet the requirements of ASU 2018-12, their CFOs will need to be ready with clear explanations for boards and shareholders about why and how financial results may appear more volatile and emerge differently than in the past. The goal is to ensure that the messages sent by the new financial statements and disclosures are perceived accurately. Life and annuity writers will face challenges as they reset existing GAAP-adjusted measures by which they analyze performance and shape their “stories” to analysts and investors.

Earnings emergence overview



In this paper, we focus on traditional long-duration contracts. Common examples of traditional long-duration contracts include term life insurance and non participating whole life insurance.

Under current US GAAP, reserves for traditional contracts are calculated with assumptions that are locked in at issue. The assumptions represent management's best estimate, with small margins for conservatism. Deferred acquisition costs (DACs) are deferred and amortized in proportion to premiums over the lifetime of the contracts. This generates an earnings pattern that is intended to be fairly stable, emerging as a level percent of premium adjusted for the release of the conservatism in the assumptions and for actual vs. expected experience differences as they occur. Reserves net of DAC assets for groups of policies are tested for adequacy and strengthened if found to be inadequate. Though these occasional "loss recognition" events may cause significant one-time shocks to earnings, they are not frequent and affect only unprofitable lines of business.

Application of new guidance under ASU 2018-12 is expected to result in greater financial statement volatility from period to period, though it also eliminates the occasional shocks from loss recognition events. This is because the calculation of the liability for future policyholder benefits will use current best estimate assumptions with updates to the assumptions impacting earnings in the current period. This new liability calculation could generate large movements in reserves when updating assumptions, with the movements coming through net income in the current period.

Changes to DAC amortization in the new guidance will impact earnings emergence as well. DAC will be amortized at a constant level over the expected term of the contract, independent of profitability. This new principle consolidates DAC amortization methodologies: whereas multiple approaches apply under current GAAP, most insurance products will now use the same principle to amortize DAC. Under the new methodology, DAC amortization for traditional long-duration contracts will be disconnected from the primary source of revenue in the contracts, the premiums paid by policyholders. In addition, the new guidance eliminates testing for recoverability of DAC, so the occasional shocks to earnings from writing down DAC due to loss recognition events under current GAAP are eliminated as well.

Additional movements may be observed on the balance sheet. Rather than management's best estimate being used, as under current GAAP, discount rates will be based on a current upper-medium-grade fixed-income investment yield. The initial discount rate will be locked in at contract issue and used to determine interest expense in earnings (i.e., interest accretion rate). At each reporting date, the reserve will be re-measured using the then-current discount rate with the difference in reserves recorded to accumulated other comprehensive income. This will cause movements in liabilities from period to period that are not witnessed under current guidance, though the movements will not be reflected in net income. This method of accounting for the liability under the ASU is similar to the treatment typically afforded to available-for-sale debt securities that tend to make up the majority of life insurer invested assets.

To fully appreciate the potential implications, insurers should consider performing parallel tests to project GAAP earnings for traditional products using the ASU 2018-12 changes to understand the impacts on current year and future earnings emergence compared to current GAAP.

Simplified example of earnings emergence for a term product

To provide an illustrative example of earnings emergence, we have modeled a group of 10-year level-premium term policies that lapse after the level-premium period (100% lapse in year 11). We include the following scenario assumptions:



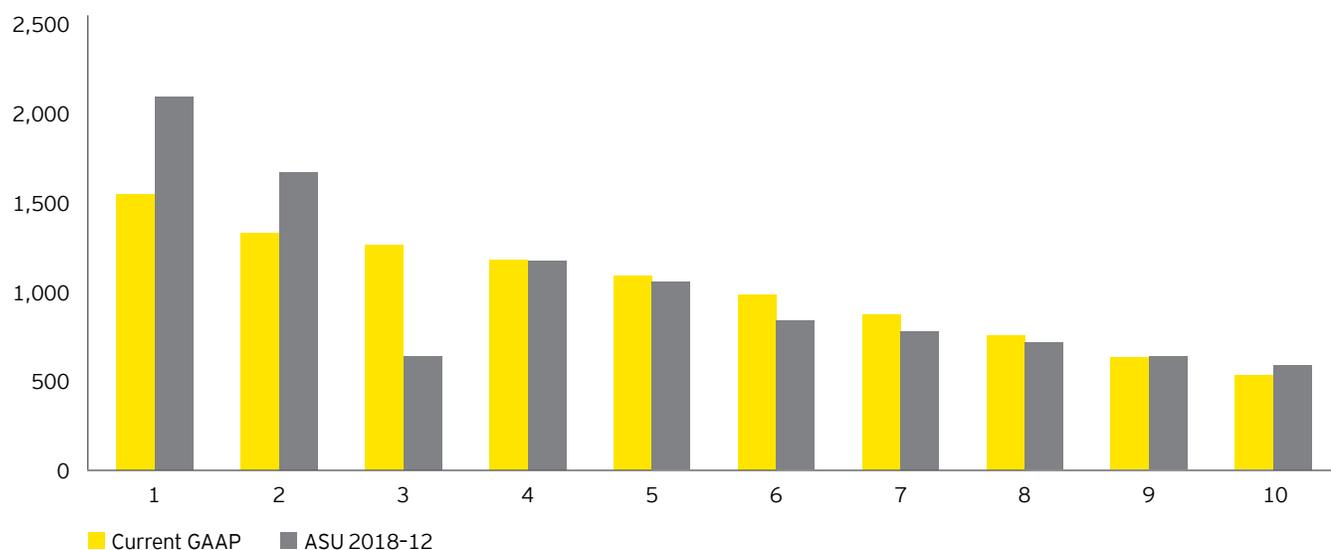
Actual death claims paid in years 1-3 are 10% higher than originally expected



At the end of year 3, the insurer updates the future mortality assumption and increases it by 10% for years 4-10

The chart below shows pre-tax income for the group of policies based on actual experience for years 1-3 and projected experience in years 4-10. Information is presented under current GAAP with locked-in assumptions and the new guidance with an unlocking of assumptions in year 3. All other aspects are held constant.

Pre-tax income



There are numerous changes between current GAAP and the new ASU. The sections below highlight the key drivers; reflecting actual mortality experience in the reserve calculation and updating the reserve calculation to reflect updated best estimate assumptions. A deep-dive of the year 3 impacts are described in a separate section below.

Years 1 and 2 earnings implications

- ▶ In this simplified model, earnings in years 1 and 2 are higher under the new guidance than under current GAAP. Under current GAAP, the additional death claims paid flow through earnings as the benefits are paid to policyholders. The reserve calculation is not impacted, and as a result, there is no mechanism to reduce the volatility in earnings caused by death claims in excess of expectations.
- ▶ Under the new ASU 2018-12 guidance, the reserve calculation is updated using a retrospective method back to contract issue to reflect the actual mortality experience to date. The updated reserve calculation results in a higher net premium ratio, which decreases the reserves in years 1 and 2. The reserve decrease partially offsets the higher death claims being paid by the insurer and reduces the volatility in earnings that is otherwise experienced as a result of adverse mortality experience.

Year 3 earnings implications

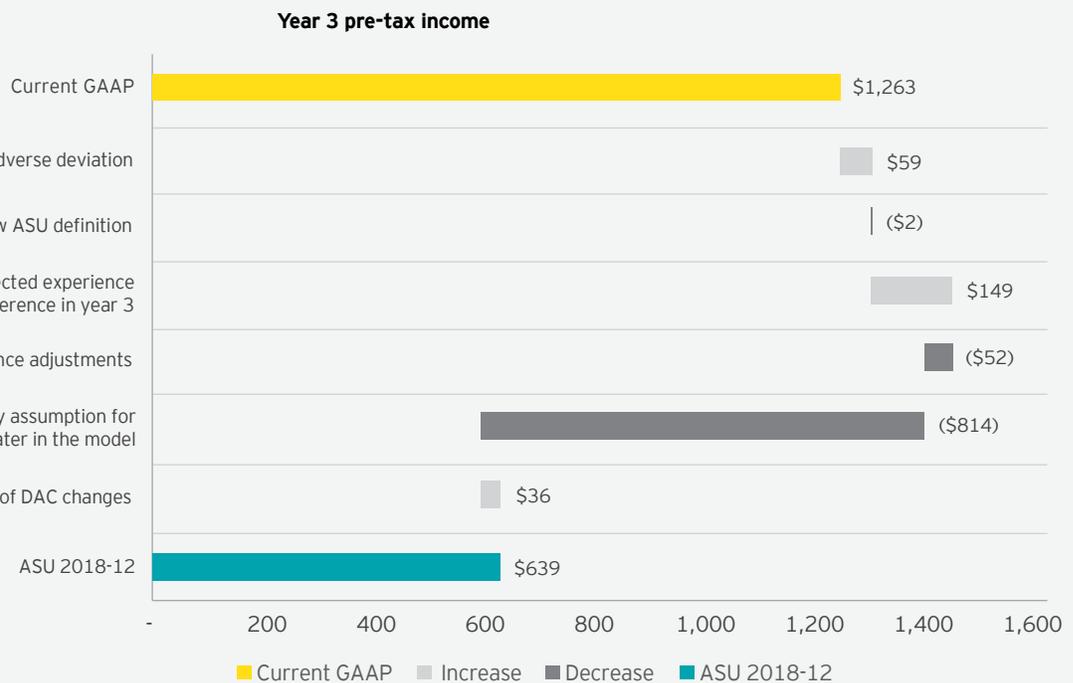
- ▶ At the end of year 3, under current GAAP, the liability model continues to use locked-in assumptions.
- ▶ Under the new ASU 2018-12 guidance, insurers will incorporate their updated future best estimate mortality assumptions in the reserve calculation. This assumption update is the primary driver of the difference between current GAAP and the new guidance, causing a one-time increase in reserves (related to expected death claims in all future periods), which decreases earnings in year 3. The update to future assumptions introduces additional volatility in earnings by recognizing immediately a portion of the expected future deterioration in experience that otherwise would have been recognized over time under current GAAP.

Years 4-10 earnings implications

- ▶ In years 4 and beyond, actual experience emerges as expected compared to the current best estimate assumptions that were updated at the end of year 3. The differences in pre-tax income between current GAAP and the new guidance are all due to subsequent impacts from the events in years 1-3 or a result of the fundamental changes under the new guidance (e.g., changes to DAC amortization).
- ▶ It's important to note that total earnings over the lifetime are unchanged in this simplified example. The changes under the new guidance only affect how quickly or slowly earnings emerge.

Deep dive on year 3

- ▶ As noted in the year 3 earnings implications section above, the largest impact is from the updating of future mortality changes. However, that is not the only change affecting pre-tax income for the year.
- ▶ The chart below summarizes the key changes driving the differences between pre-tax income under current GAAP and the new guidance under ASU 2018-12 in year 3:



Some of the impacts relate to changes to assumptions (e.g., removing provisions for adverse deviations (PADs) from best estimate assumptions and using a discount rate based on high-quality fixed income instruments rather than portfolio yield) while other impacts relate to changes to reserve or DAC mechanics (e.g., reflecting actual experience, including unwinding prior period experience adjustments, using current views of best estimate assumptions and changing the DAC amortization basis). Many of these items have offsetting impacts and can be hidden when not doing a detailed attribution.

Finance and actuarial management will need to be prepared to understand and explain each of these changes to users of the financial statements, especially as some of these changes and their effects will be presented separately or specifically disclosed in the financial statements.

Future earnings emergence

Insurance companies will need to work through different scenarios to identify implications for earnings emergence for all products in scope. Just a few of the key questions to explore:

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How will management explain the new complexity in reporting period-to-period changes to CEOs, boards, analysts and shareholders?

2

How will management explain the contribution of DAC to earnings now that the amortization basis is disconnected from profitability?

3

What impacts will the decisions made at transition have on future earnings emergence?

4

What impact will early adoption have on current and future earnings?

5

Should I use the full retrospective transition approach if the data is available? And what impact will that have on earnings emergence?

CFOs need to be prepared to explain the changes in earnings as financial results emerge differently than expected, and when assumptions are updated. Insurers that understand ASU 2018-12 and analyze its financial impacts, both at transition and for ongoing business, will be well positioned to effectively explain the impacts on future earnings emergence. This understanding will allow insurers to educate their various stakeholders well in advance of the implementation date.

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