

Technical Line

FASB – final guidance

A closer look at how insurers will have to change their accounting and disclosures for long-duration contracts

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What you need to know

- ▶ The new guidance in ASU 2018-12 will significantly change how insurers account for and make disclosures about long-duration contracts.
- ▶ When measuring liabilities for future policyholder benefits, insurers will have to review and, if necessary, update the assumptions they use to project future cash flows, and the rate they use to discount those future cash flows so the discount rate reflects the yield on upper-medium grade fixed-income instruments.
- ▶ The guidance creates a new category of market risk benefits that insurers will have to measure at fair value and reduces the number of methods used to amortize deferred acquisition costs. It also significantly expands the related disclosures.
- ▶ Insurers will have to change their processes, systems and internal controls to apply the new guidance.
- ▶ The guidance is effective for all PBEs for fiscal years beginning after 15 December 2020 and for interim periods in those years. All other entities must apply the guidance for fiscal years beginning after 15 December 2021 and interim periods the following year. Early adoption is permitted.

Overview

The new guidance the Financial Accounting Standards Board (FASB or Board) issued in Accounting Standards Update (ASU) 2018-12¹ will significantly change how insurers account for and make disclosures about long-duration contracts. The changes are intended to provide users

of the financial statements with more meaningful information about the amount, timing and uncertainty of an insurer's cash flows related to long-duration contracts. To meet this objective, ASU 2018-12 changes the accounting and financial reporting for long-duration contracts by:

- ▶ Requiring insurers to more timely recognize changes in the liability for future policyholder benefits and modify the rate used to discount the liability
- ▶ Making the accounting for certain benefits embedded in deposit or account balance contracts simpler to apply and more consistent
- ▶ Simplifying the amortization of deferred acquisition costs (DAC)
- ▶ Requiring significantly more disclosures, including rollforwards of disaggregated balances for insurance liabilities and DAC, as well as quantitative and qualitative information about significant inputs, judgments and assumptions used in the measurement of such disaggregated amounts

The guidance is the final step in the FASB's insurance project. The FASB split the project into two parts, long-duration contracts and short-duration contracts, after the Board decided to change the direction from an earlier proposal to overhaul the accounting for insurance contracts that it worked on jointly with the International Accounting Standards Board (IASB). The FASB issued a final standard² in 2015 that requires insurers to make additional disclosures about their short-duration contracts. The IASB issued its new IFRS standard³ for insurance contracts in May 2017.

This publication is designed to help entities better understand and interpret ASU 2018-12. Appendix A compares the new guidance with the existing guidance in Accounting Standards Codification (ASC) 944, *Financial Services – Insurance*, and Appendix B provides a summary of the new disclosure requirements.

The interpretations we provide in this publication are preliminary and are subject to change as more information becomes available. We may identify additional issues during implementation, and our views may evolve during that process.

Recognition and measurement

Liability for future policyholder benefits for traditional long-duration and limited-payment contracts

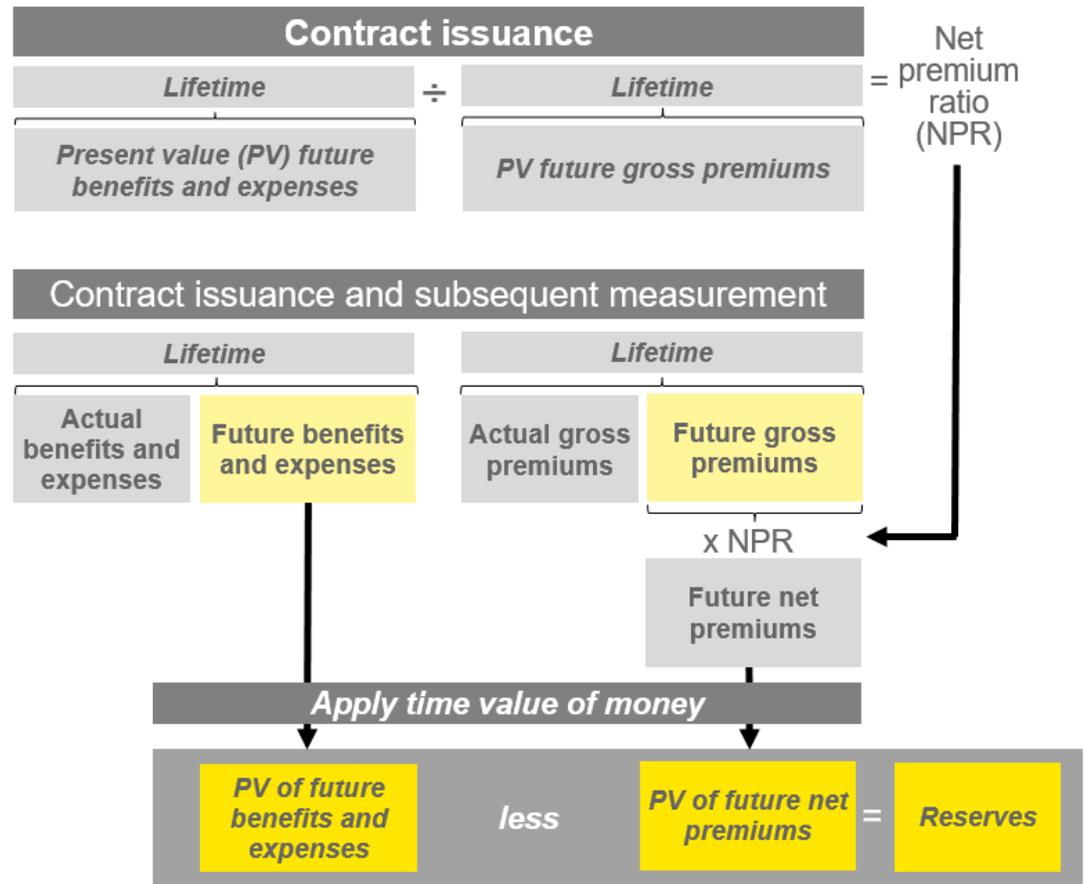
Although the new guidance retains the fundamental net premium model for traditional long-duration and limited-payment contracts, it requires insurers to review and update assumptions if necessary and record any resulting change to the liability for future policyholder benefits on a cumulative catch-up basis in the period in which assumptions are updated. That is, net premiums will continue to drive the measurement of the liability with related changes in the liability affecting net income.

When measuring reserves for future policyholder benefits under the net premium model, the following steps are applied. First, a net premium ratio is calculated at contract issuance by dividing the present value of the estimated lifetime policyholder benefits and certain related expenses by the present value of estimated lifetime gross premiums.

The net premium ratio is then multiplied by the future gross premiums to calculate the net premiums, which are the portion of the future gross premiums required to provide for all future policyholder benefits and certain related expenses. Both the future net premiums and the future policyholder benefits and certain related expenses are then discounted to present value.

The present value of the future net premiums is then subtracted from the present value of future policyholder benefits and certain related expenses to determine the reserve for future policyholder benefits.

The following table illustrates these steps:



Updating assumptions under current guidance

Under current guidance, the assumptions used in measuring reserves for policyholder benefits at contract issuance are “locked in” (i.e., not updated) unless a premium deficiency exists (i.e., loss recognition). These assumptions include a provision for adverse deviation to address reasonable unfavorable deviations from assumptions determined at contract issuance.

If a premium deficiency exists, the insurer updates its assumptions to current best estimates (i.e., without provision for adverse deviation). If a premium deficiency does not exist, the net premium remains unchanged over the life of the policy. This results in income recognition over the life of the contract as a level percentage of net premiums, with differences between initial expected and actual experience recognized in income in the periods incurred.

Updating of cash flow assumptions and the net premium ratio under ASU 2018-12

ASU 2018-12 requires cash flow assumptions used in the net premium model (e.g., mortality, morbidity, terminations) to be reviewed at least annually in the same period each year. These assumptions should be updated if warranted and a new net premium ratio should be calculated, rather than remaining unchanged absent a premium deficiency. Because insurers will update assumptions in the net premium model, the FASB concluded that a provision for risk of adverse deviation in the assumptions is no longer needed.

In the Background Information and Basis for Conclusions of ASU 2018-12, the FASB clarified that insurers are not expected to revise the net premium ratio every quarter for actual experience and changes in future expectations unless evidence suggests that the cash flows should be updated. That is, on an interim basis, if the ultimate cash flows are not expected to change, insurers will not be required to revise the net premium ratio. However, at least annually, insurers are required to recalculate the net premium ratio to reflect actual experience, as well as updated expected future cash flow assumptions if the required annual review of assumptions indicates the assumptions should be updated.

A review of assumptions should be performed more frequently (e.g., in an interim reporting period other than the one in which the insurer performs its annual review) if evidence suggests the assumptions should be updated. We generally believe all assumptions included in the measurement for a particular unit of account should be reviewed concurrently.

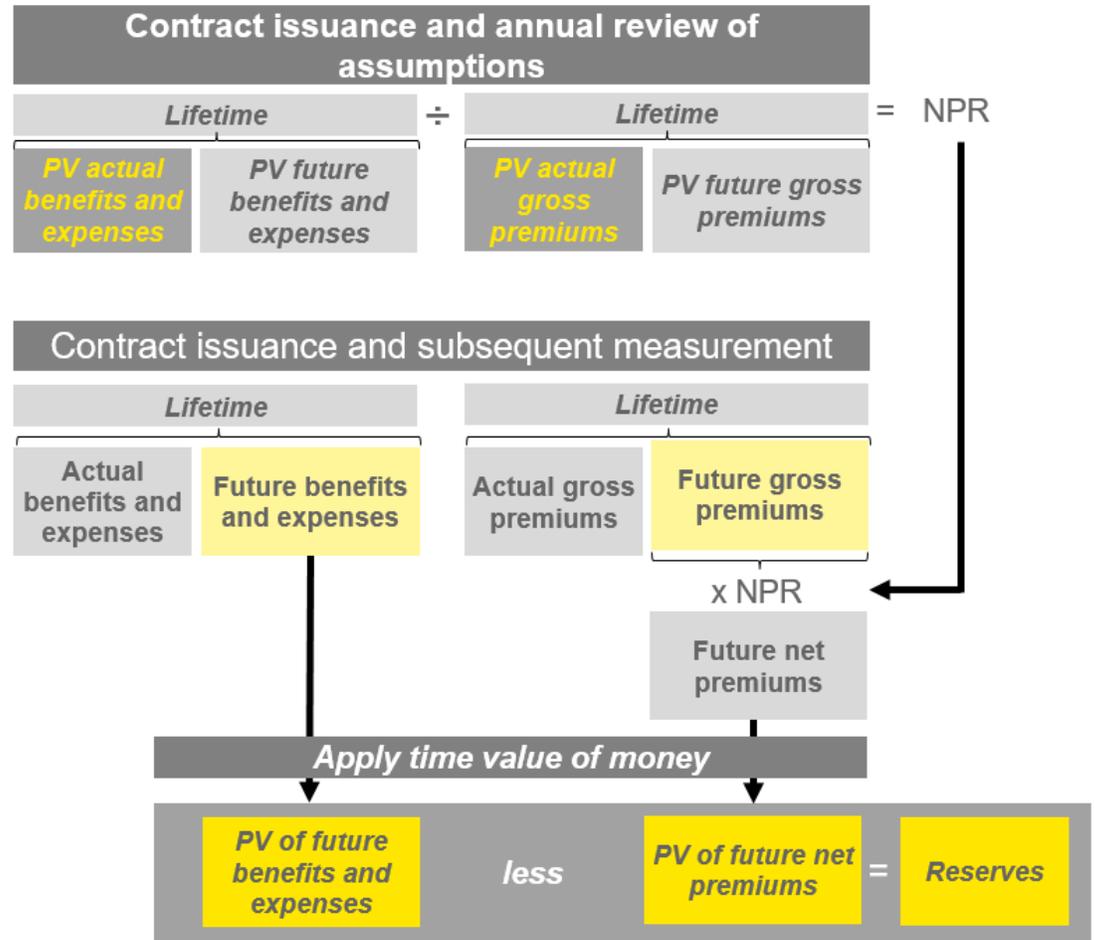
Under ASU 2018-12, insurers must determine the unit of account (also referred to as the cohort) for which the liability for policyholder benefits is measured. ASU 2018-12 does not provide specific guidance regarding grouping contracts from different product lines. Therefore, we expect that current practice will not change where insurers generally group contracts exhibiting homogenous characteristics (i.e., product lines). However, when determining the cohort under ASU 2018-12, insurers may group contracts issued in the same quarter or year but may not group contracts from different issue years. Insurers can elect for each cohort the date when they perform their annual review of assumptions.

For contracts acquired in a business combination, insurers must use the acquisition date as the contract issuance date for purposes of determining the unit of account that will be measured. That is, a cohort of acquired contracts could include contracts from different issue years. Insurers may consider applying this guidance by analogy when determining the unit of account for blocks of in-force insurance acquired in a reinsurance arrangement.

When updating assumptions, insurers are not required under ASU 2018-12 to update the expense assumptions in the net premium model. Insurers may make an entity-wide election to retain the expense assumptions determined at contract issuance in the net premium model. An insurer making this entity-wide election would immediately recognize in income the effect of actual expense experience that deviates from its expectation at contract issuance, without affecting the liability for policyholder benefits. The expense assumptions often reflect an allocation of certain expenses related to the insurer's activity to fulfill its obligation under the insurance contracts, and we would generally expect that updating these assumptions would not have a material effect on the calculation of the net premium ratio. In considering this, the Board indicated that the costs to update the expense assumptions outweighed the benefits.

Consistent with current guidance, the expense assumptions used in estimating the liability under ASU 2018-12 should include estimates of expected nonlevel costs, including termination or settlement costs, costs after the premium-paying period and the effect of inflation on renewal expenses. However, the FASB clarified in the new guidance that "expense assumptions shall not include acquisition costs or costs that are required to be charged to expense as incurred, such as those relating to investments, general administration, policy maintenance, product development, market research and general overhead."

Insurers will review cash flow assumptions on an annual basis and update them as needed, or more frequently if warranted.



As shown in the graphic above that illustrates revisions to the net premium model as a result of ASU 2018-12, the annual recalculation of the net premium ratio considers all lifetime cash flows (actual and expected future cash flows discounted at the discount rate determined at contract issuance) for a group of contracts. As a result, the recalculated net premium ratio used in remeasuring the liability for policyholder benefits results in a liability that reflects the insurer’s current cash flow assumptions. An insurer will apply the revised net premium ratio until the ratio determined during the annual review of assumptions is revised in a future reporting period. See the *Measuring and accounting for changes in discount rate assumptions* section for details on the discount rate used in the initial and subsequent measurement of the liability.

However, for contracts that are transitioned using the modified retrospective transition approach, the lifetime present value of cash flows (both actual cash flows and expected future cash flows) should represent those cash flows after the transition date with an adjustment for the related balances recorded before transition. See the *Transition and effective date* section for details on the net premium ratio calculation under the modified retrospective transition approach, which will continue to be applied in subsequent periods after an insurer adopts ASU 2018-12.

How we see it

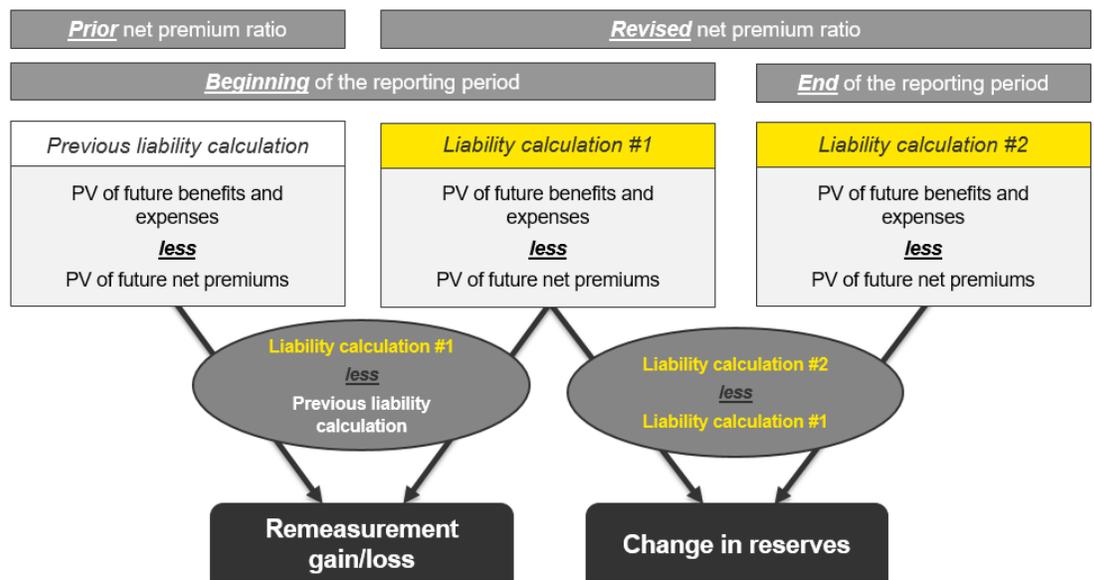
- Insurers will have to maintain more detailed records about their actual experience since contract issuance, including information on contracts that have expired due to mortality or lapse, to calculate the revised net premium ratio. An insurer will need to change its processes, systems and controls to retain the necessary information.

- Expenses included in the estimate of the liability for future policyholder benefits will be limited to nonlevel costs (e.g., termination or settlement costs), costs after the premium-paying period and the effect of inflation on renewal expenses. This may be a change for some insurers.

Determining the cumulative catch-up adjustment

Under ASU 2018-12, in a period when the net premium ratio has been recalculated, insurers will use the recalculated net premium ratio to remeasure the liability for future policyholder benefits (i.e., change the liability due to updates for experience and expected future cash flow assumptions discounted using the discount rate at contract issuance) as of the beginning of the current reporting period. The difference between the current and previous liability measurement represents a cumulative catch-up reported separately as a component of total benefit expense in net income as a “remeasurement gain or loss” in the period. The insurer will also use the same recalculated net premium ratio to calculate the liability for future policyholder benefits as of the end of the reporting period. The difference between the liability remeasured as of the beginning of the reporting period and the liability measured as of the end of the reporting period will be recognized in net income as a component of benefit expense (e.g., change in reserves). The following diagram summarizes these steps.

The effect of updated cash flow assumptions will be recorded as a cumulative catch-up adjustment in the current reporting period.



The Board determined that this approach will more accurately depict the insurer’s current liability for future policyholder benefits and better reflect the effect of the updated assumptions for the entire contract period. This is because insurers will recognize a portion of the effect related to prior periods as a cumulative catch-up adjustment in income and a portion of the effect in future periods, thus resulting in a best estimate of profit emergence over the remaining contract period.

Illustration 1 – Updating assumptions used in the measurement of the liability for future policyholder benefits

Consider an example in which an insurer has unfavorable mortality experience on a block of 10-year level premium term life insurance contracts. The policies lapse with declining frequency over time until the end of year 10, when all remaining policies lapse.

The following table demonstrates the expected benefits and expenses and projected reserve balance at each year end, as of the contract issue date. For simplicity purposes, the discount rate is kept constant at 3%, and therefore the example demonstrates the effects of updating cash flow assumptions and the cumulative catch-up application of the model.

Year	Premiums received	Benefits and expenses paid	Reserve balance
1	\$ 16,000	\$ 4,349	\$ 5,495
2	13,598	5,414	8,559
3	11,962	6,179	9,908
4	10,881	6,354	10,444
5	10,114	6,634	10,229
6	9,401	6,831	9,360
7	8,737	6,949	7,930
8	8,120	7,050	5,967
9	7,546	7,289	3,342
10	7,011	7,585	-
Total present value	\$ 92,781	\$ 56,150	

At contract issuance, using the constant discount rate of 3%, the insurer estimates the present value of lifetime gross premiums to be \$92,781 and the present value of lifetime benefits and expenses to be \$56,150. These estimated cash flows result in a net premium ratio of 60.52% (56,150 divided by 92,781). During year 1, actual experience is in line with the insurer's expectations. Net premiums are determined using the original net premium ratio, and as of the end of year 1, the liability for future policyholder benefits is measured as follows:

Benefits and expenses (for years 2-10) discounted at 3%	(a)	\$ 53,355
Net premiums (for years 2-10) discounted at 3%	(b)	47,860
Measured liability = (a) – (b)	(c)	5,495

In year 2, the insurer experiences unfavorable mortality, resulting in actual benefits and expenses of \$7,341, which are \$1,927 higher than the \$5,414 originally expected. The insurer concludes that an update to future cash flow assumptions is not needed.

As required by the guidance, the insurer calculates a revised net premium ratio as of the contract issue date with the inclusion of the additional \$1,927 of actual claims experience. The present value of the additional year 2 claims is \$1,870, and the resulting revised net premium ratio is 62.53% (present value of benefits and expenses of \$58,020 (total of \$56,150 in original calculation plus \$1,870) divided by present value of gross premiums of \$92,781), and the insurer applies this revised ratio to calculate a remeasured reserve as of the beginning of the reporting period (i.e., beginning of year 2 calculation).

Benefits and expenses (for years 2-10) discounted at 3%	(a)	\$ 55,282
Net premiums (for years 2-10) discounted at 3%	(b)	49,455
Remeasured liability = (a) – (b)	(c)	5,827

The following table compares the expected premiums, benefits and expenses, and projected reserve balance at each year end as of the contract issue date with those as of the end of year 2.

Year	At contract issuance			Updated for year 2		
	Premiums received	Benefits and expenses paid	Reserve balance	Premiums received	Benefits and expenses paid	Reserve balance
1	\$ 16,000	\$ 4,349	\$ 5,495	\$ 16,000	\$ 4,349	\$ 5,827
2	13,598	5,414	8,559	13,598	7,341	7,199
3	11,962	6,179	9,908	11,962	6,179	8,756
4	10,881	6,354	10,444	10,881	6,354	9,483
5	10,114	6,634	10,229	10,114	6,634	9,449
6	9,401	6,831	9,360	9,401	6,831	8,752
7	8,737	6,949	7,930	8,737	6,949	7,485
8	8,120	7,050	5,967	8,120	7,050	5,678
9	7,546	7,289	3,342	7,546	7,289	3,201
10	7,011	7,585	-	7,011	7,585	-

The first three columns represent the original assumptions and demonstrate the projected reserves at contract issuance, while the last three columns represent projections updated after year 2 experience. For simplicity purposes, the projected premiums are unchanged and the only difference in benefits is an increase in year 2. The difference between the remeasured reserve balance as of the beginning of the current reporting period (using the revised net premium ratio) and the recorded reserve balance as of the same period of \$332 (\$5,827 less \$5,495) is the remeasurement loss for the period.

The same revised net premium ratio is used to measure the liability at the end of year 2, resulting in a change in reserves of \$1,372 (\$7,199 less \$5,827). The applicable amounts for year 2 are highlighted in the table above, and total benefit expense for the period is calculated as follows:

Reserve calculations	Amount included in benefit expense	
Original reserve, beginning of year 2	\$ 5,495	
Remeasured reserve, beginning of year 2*	5,827	\$ 332 (remeasurement loss)
Reserve, end of year 2	7,199	1,372 (change in reserves)
		<u>7,341</u> (benefits paid)
Total benefit expense		<u>\$ 9,045</u>

* **Note:** For simplicity purposes, the beginning of the annual period is used for purposes of determining the remeasurement loss. However, insurers that prepare quarterly financial statements may elect to use the beginning of a quarterly period for purposes of determining the remeasurement gain or loss.

As previously noted, the year 2 benefits and expenses were \$1,927 higher than originally expected. However, this increase in cash payments was offset by a \$1,360 drop in reserves to \$7,199, which was actually recorded as of the end of year 2 using the revised net premium ratio from \$8,559, which was originally expected as of the end of year 2. This mitigation is a result of the cumulative catch-up mechanism under the new guidance and can exist when experience deviates from original expectations, but not to a degree requiring a change to future cash flow assumptions.

To further extend the example, assume in year 3 the insurer experiences a second consecutive year of unfavorable mortality and the insurer concludes an update to future cash flow assumptions is needed.

Year	Amounts updated as of year 2			Updated for year 3		
	Premiums	Benefits and expenses	Reserve balance	Premiums	Benefits and expenses	Reserve balance
1	\$ 16,000	\$ 4,349	\$ 5,827	\$ 16,000	\$ 4,349	\$ 7,741
2	13,598	7,341	7,199	13,598	7,341	10,796
3	11,962	6,179	8,756	11,962	8,566	11,433
4	10,881	6,354	9,483	10,877	7,614	12,240
5	10,114	6,634	9,449	10,109	7,981	12,108
6	9,401	6,831	8,752	9,395	8,241	11,158
7	8,737	6,949	7,485	8,730	8,403	9,505
8	8,120	7,050	5,678	8,112	8,542	7,188
9	7,546	7,289	3,201	7,537	8,853	4,041
10	7,011	7,585	-	7,001	9,233	-

The first three columns represent the assumptions updated as of the end of year 2 and demonstrate the projected reserves at that time, while the last three columns represent projections updated after year 3 experience. An increase in benefits in year 3 is reflected, and because the insurer updated future cash flow assumptions, the projected premiums and benefits for years 4 through 10 are also updated. The revised net premium ratio after updating for the actual benefits and updated future cash flow assumptions is calculated as 74.15% (present value of benefits and expenses of \$68,766 divided by present value of gross premiums of \$92,741).

The insurer applies this revised ratio to calculate a remeasured reserve as of the beginning of the reporting period (i.e., beginning of year 3 calculation).

Benefits and expenses (for years 3-10) discounted at 3%	(a)	\$ 60,779
Net premiums (for years 3-10) discounted at 3%	(b)	49,983
Remeasured liability = (a) – (b)	(c)	10,796

The difference between the remeasured reserve balance as of the beginning of the current reporting period (using the revised net premium ratio) and the previously measured reserve balance at the beginning of the current reporting period of \$3,597 (\$10,796 less \$7,199) is the remeasurement loss for the period. The same revised net premium ratio is used to measure the liability at the end of year 3 resulting in a change in reserves of \$637 (\$11,433 less \$10,796).

Reserve calculations	Amount included in benefit expense	
Original reserve, beginning of year 3	\$ 7,199	
Remeasured reserve, beginning of year 3	10,796	\$ 3,597 (remeasurement loss)
Reserve, end of year 3	11,433	637 (change in reserves)
		<u>8,566</u> (benefits paid)
Total benefit expense	<u>\$12,800</u>	

Note that in this instance, unfavorable experience is still mitigated by the cumulative catch-up mechanism, but the mitigation is overcome due to the insurer updating future cash flow assumptions based on the expectation of future unfavorable experience. As a result, a larger remeasurement loss is recorded.

How we see it

- ▶ Updating cash flow assumptions periodically throughout the life of the contract will result in periodic fluctuations in income that may have been deferred to future periods under today's model.
- ▶ A portion of the effect of current-period changes in assumptions will be reflected immediately in income (i.e., remeasurement gain or loss) and the remainder of the effect will be reflected in future periods as an adjustment to cash flows in the net premium model using the revised net premium ratio.
- ▶ The guidance does not specify whether the "beginning of the current reporting period" when determining a remeasurement gain or loss refers to the annual period or the current interim period, but we believe it would be reasonable for an insurer to consider the remeasurement as a change in estimate (i.e., calculate as of the beginning of the current quarter for either quarterly or annual financial statements).
- ▶ The current period change in reserves (i.e., the difference between actual experience and expected experience) will continue to be reflected immediately in net income. However, the net effect of the change in net income will be mitigated if the actual experience does not affect the overall expectations for that assumption over the life of the contract due to the inclusion of the actual experience in the revised net premium ratio.

Adjustments to results of the net premium model

Consistent with current guidance and to prevent insurers from deferring losses to future periods, ASU 2018-12 will require insurers to recognize a loss in income (and a corresponding increase in the liability for future policyholder benefits) in the current period if the present value of future expected benefits and expenses exceeds the present value of future gross premiums (i.e., cap the net premium ratio at 100% so the net premiums may never exceed the gross premiums). If subsequent updates to cash flow assumptions result in the present value of future gross premiums exceeding the present value of future expected benefits and expenses (i.e., the net premium ratio is below 100%), the insurer should remeasure the liability for future policyholder benefits using the revised net premium ratio.

In addition, the Board decided that the liability for future policyholder benefits cannot be less than zero (nor can the insurer record an asset) at the level of aggregation at which reserves are calculated (i.e., unit of account or cohort).

Discount rate assumptions

ASU 2018-12 will require insurers to discount the liability for future policyholder benefits for traditional long-duration and limited-payment contracts using upper-medium grade fixed-income instrument yields that reflect the duration characteristics of the liability and maximize the use of observable inputs. An upper-medium grade yield is generally interpreted as a single A or equivalent rating from a globally recognized statistical rating organization. An insurer will only substitute its own estimates for observable market data when market data reflects transactions that are not orderly.⁴ Because the timing of expected future cash flows varies, insurers often calculate discount rates using a yield curve.

Under the new guidance, this calculation will be based on single A rates for each expected cash flow duration. For points on the yield curve in which there are limited or no observable market prices, the insurer will need to apply a methodology similar to what is required for Level 3 fair value measurements in ASC 820.⁵ That is, it will develop discount rate assumptions using the best information available to determine the upper-medium grade fixed-income instrument rate that reflects the duration characteristics of the liability. If the duration characteristics of the observable inputs differ from those of the liability, the discount rates will need to be adjusted to reflect this difference. Expected cash flows would be discounted at the rate on the yield curve matching the duration.

Determining the yield curve based on single A rates is a change from current guidance, where an insurer uses its expected investment yield to discount the liability for future policyholder benefits. In the Basis for Conclusions, the FASB noted that, under current guidance, duration risk and the spread between the return on investment and time value of the liability are not transparent to financial statement users.

The FASB also noted that an insurer is obligated to satisfy its benefit obligations regardless of its investment strategy and acknowledged that the proper rate to discount a guaranteed liability is a liability rate (i.e., a discount rate implicit in the insurance contract based on its contractual cash flows), rather than a rate linked to the insurer's investment experience. However, the FASB also noted that a liability rate is conceptually and practically challenging to calculate for long-duration contracts. Therefore, the FASB concluded that a fixed-income instrument yield would be operationally easier to determine, and an independent market observable rate allows for better comparability among insurers.

Insurers will discount the liability for future policyholder benefits using upper-medium grade fixed-income instrument yields.

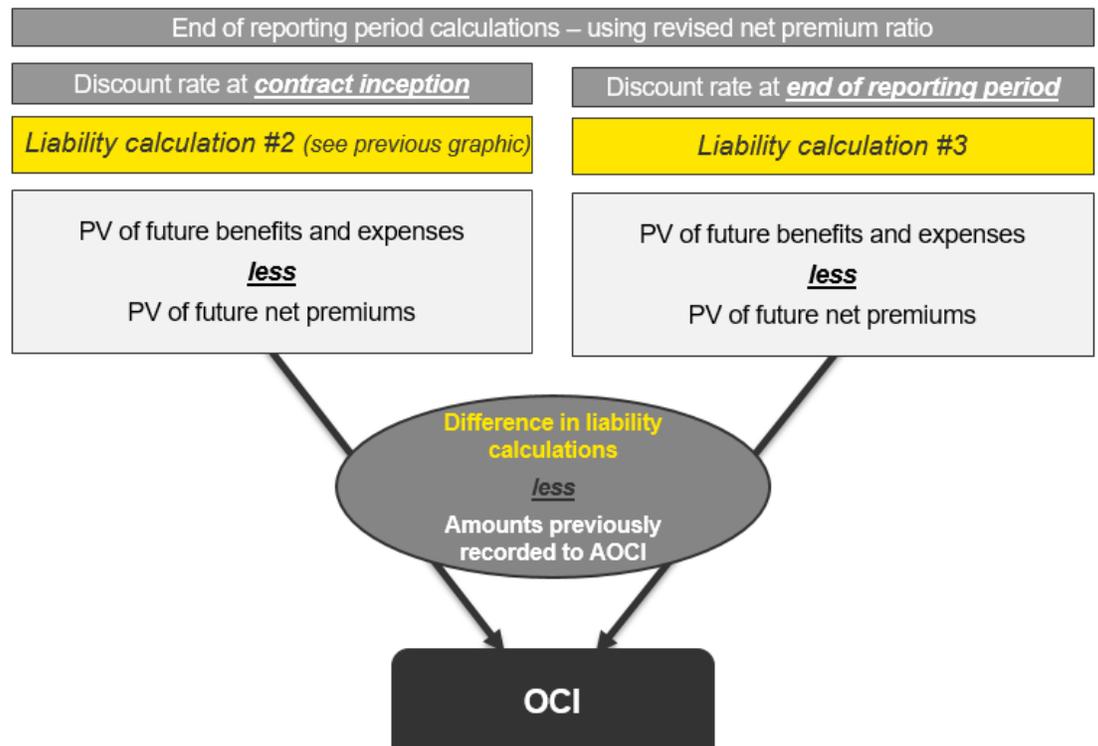
How we see it

- ▶ An insurer will need to determine the expected duration of its benefit obligations and identify the upper-medium grade fixed-income instruments that will be of a similar duration to calculate the discount rate. Since the duration of many long-duration contracts may exceed the duration of available investment assets, the insurer will need to apply the principles of ASC 820 when observable inputs are not available for the duration of the liability.
- ▶ There could be diversity in how insurers determine the upper-medium grade fixed-income instrument yield used to discount cash flows when measuring the liability. However, the differences in rates are likely to be narrower than under today's accounting.
- ▶ Insurers that have pension liabilities may want to consider their process for determining the discount rate for their pension obligations, because the accounting requirements to determine the discount rate for long-duration contracts may have similarities.

Measuring and accounting for changes in discount rate assumptions

ASU 2018-12 will require insurers to update at each reporting date the discount rate used to measure the liability for future policyholder benefits for traditional long-duration and limited-payment contracts that is recorded in the statement of financial position. At each reporting date, insurers will compare the liability measured using the discount rate at contract inception to the liability measured using the updated discount rate. The difference is recorded in other comprehensive income (OCI), similar to recording unrealized gains and losses on securities categorized as available for sale. In subsequent periods, the insurer will also adjust the current period amount recorded to OCI for any amounts previously recorded in accumulated other comprehensive income (AOCI).

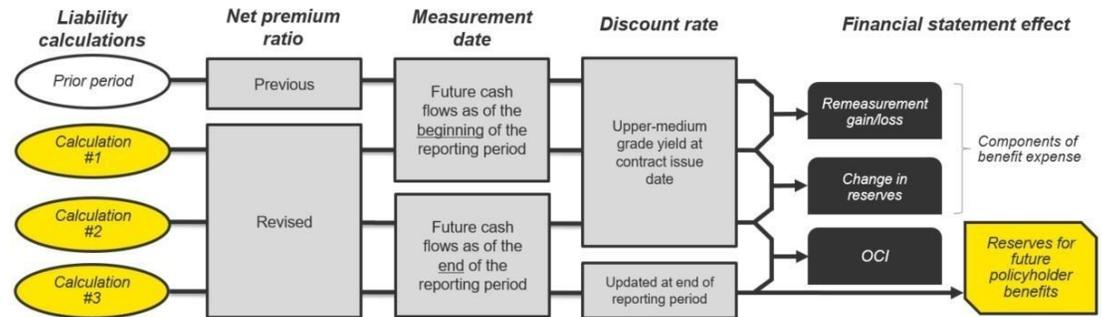
The following chart illustrates these steps:



While the measurement of the liability for future policyholder benefits is recorded using the current discount rate, the liability is accreted using the discount rate set at the contract issue date (referred to as the interest accretion). This will affect measurement of both the remeasurement gain or loss and the change in reserves, and therefore the effect of interest accretion will be recognized within benefit expense. The guidance does not explicitly address whether an insurer should base the interest accretion rate on a yield curve or a single effective yield (or weighted-average yield) that produces the same net result at inception. One approach to accreting interest on the liability for policyholder benefits would be to derive the implied forward rates from the spot curve (sometimes referred to as “rolling forward on the curve” or “moving along the curve”). Another approach would be to use an effective yield method. There are other approaches that an insurer can apply, but it is important for the insurer to consistently apply the method it selects.

As discussed in the *Updating of cash flow assumptions and the net premium ratio under ASU 2018-12* section, before the final liability calculation of the reporting period, which uses the current net premium ratio and current discount rate, all present value calculations (both when determining the net premium ratio and when calculating the income statement effects)

are performed using the discount rate set at the contract issue date. This isolates the effect of the changes in the discount rate and separately recognizes these changes in OCI as shown in the diagram below.



How we see it

- ▶ Insurers will need to develop processes and controls to perform multiple calculations to isolate various effects (i.e., remeasurement gain/loss, benefit expense and OCI impact) when measuring the liability for future policyholder benefits.
- ▶ Recognizing the effect of the current discount rate in OCI will align the presentation of the effect of interest rates on the insurer’s liabilities with the portion of its investments classified as available for sale. However, this accounting alignment could highlight a mismatch in the duration of the liabilities and assets, which insurers should be prepared to explain to users of the financial statements.

The effect of updating the discount rate used to measure the liability for future policyholder benefits each reporting period will be reported in OCI.

Deferred profit liability for limited-payment contracts

Limited-payment policies are similar to traditional long-duration policies, except that policyholders pay premiums for a predetermined period while the benefit period extends for a longer duration. Consistent with current guidance, ASU 2018-12 will require any gross premiums received in excess of the net premiums to be deferred and recorded as a separate deferred profit liability. Any deferred profit liability will still be recognized in income in a constant relationship with the insurance in force for life insurance contracts or with the amount of expected future benefit payments for annuity contracts.

Under ASU 2018-12, cash flow assumptions included in the measurement of the deferred profit liability will be reviewed at the same time as those in the net premium model (at least annually). Updates to the cash flow assumptions will be used to recalculate the contract issuance date deferred profit liability as if the updated assumptions were in place at the contract issuance date. The revised deferred profit liability as of the contract issuance date is then amortized based on updated insurance in force for life contracts or expected future benefit payments for annuity contracts to derive the revised deferred profit liability as of the beginning of the reporting period. The difference between the revised deferred profit liability and the previously recorded liability will be recognized as a cumulative catch-up adjustment in net income.

Interest will accrue to the unamortized balance of the deferred profit liability using the contract issuance discount rate for the related policyholder liability.

Liability for future policyholder benefits for participating life contracts

Participating contracts provide policyholders with certain guaranteed and discretionary benefits and dividends that are paid periodically and reflect the insurer’s experience and investment performance, mortality and contract administration costs for each contract class. ASU 2018-12 does not change today’s guidance for the liability for future policyholder benefits of participating contracts, other than the recognition pattern of terminal dividends.

Today's guidance acknowledges participation features and requires the future policyholder benefit liability to be recorded using the net premium model (with assumptions for the guaranteed mortality and dividend fund interest), which is a proxy for account balances (at the portfolio level). This model results in an expectation that profits will be recognized as a level percentage of margin over the entire life of the contracts. Only assumptions for mortality and discount rates are included in the net premium model. ASU 2018-12 does not require these assumptions to be updated.

Also under today's guidance, there is no explicit policyholder dividend assumption included in the net premium model. However, insurers are required to record a separate liability for terminal dividends (i.e., dividends to policyholders calculated and paid upon termination of a contract). Terminal dividends are accrued over the life of the contract in proportion to the present value of the estimated gross margin expected to be realized. Interest accrues to the terminal dividend liability using the insurer's expected investment yield, net of related investment expenses.

ASU 2018-12 modifies the recognition pattern of terminal dividends so they are accrued at a constant rate based on the present value of the basis used for the amortization of DAC. See the *Deferred acquisition costs* section for discussion regarding the basis to be used for DAC amortization.

How we see it

Because ASU 2018-12 retains the guidance for measuring the liability for future policyholder benefits of participating contracts, the measurement model for these types of contracts will continue to differ from that of traditional long-duration and limited-pay contracts.

Liability for unpaid claims and claim adjustment expenses

The new guidance does not clarify the rate at which the liability for unpaid claims and claim adjustment expenses (CAE) on long-duration contracts should be discounted or whether it needs to be updated after the claim date.

Some insurers analogize to SEC Staff Accounting Bulletin Topic 5.N (which provides guidance for property-casualty insurers on discounting claims liabilities when the payment pattern is fixed and determinable using a reasonable rate based on facts and circumstances) and discount these liabilities using a best estimate of investment yields net of related investment expenses (which is one of several rates that could be used) as of the claim date. This approach is consistent with the discount rate applied to the liability for future policyholder benefits under the current guidance.

How we see it

- ▶ We believe it would be reasonable for insurers to discount the liability for unpaid claims and CAE on long-duration contracts using either the upper-medium grade fixed-income instrument yield that will be used to discount the liability for future policyholder benefits under the new guidance or a reasonable rate based on facts and circumstances under the insurer's existing policy, which may be the expected investment yield.
- ▶ The approach elected to determine the discount rate to be used in the measurement of the claims and CAE should be consistent each period and for all future claims.

Additional liabilities for benefit features

Certain long-duration products such as universal life-type or investment contracts may be sold with contract features that provide for benefits in addition to the account balance. The insurer’s obligation to cover any shortfall between the guaranteed benefits and the account balance is the insurer’s net amount at risk and exposes the insurer to capital market risk. These types of contract features often take the form of an annuitization, death or withdrawal benefit in excess of the policy’s stated account value and are often offered through separate account products. However, they can also be offered through a general account product (e.g., fixed indexed annuities).

ASU 2018-12 creates a new category of benefit features called market risk benefits that will be measured using a fair value model similar to that currently used for embedded derivatives. Under current guidance, depending on the characteristics of the benefit feature, these features are accounted for as bifurcated embedded derivatives recorded at fair value under ASC 815⁶ or as insurance liabilities under the benefit ratio model in ASC 944 (formerly known as the Statement of Position 03-1⁷ liability), or they are not required to be recorded.

At contract inception, an insurer will be required to first evaluate whether benefit features meet the criteria of a market risk benefit. If they do not, the insurer will then evaluate whether the features meet the criteria of an embedded derivative that requires bifurcation under ASC 815. All other benefit features should be accounted for under today’s insurance liability benefit ratio model, which has been retained (see *Annuitization, death or other insurance benefits – measurement* section).

Insurers will still have to determine which accounting model to apply to additional benefit features in insurance contracts.

Illustration 2 – Additional liability models for benefit features

The chart below identifies the three models that will be applied under the guidance for the recognition and measurement of benefit features.

Market risk benefits	<ul style="list-style-type: none"> ▶ Any benefit features that protect the policyholder’s account balance from and expose the insurer to capital market risk (e.g., guaranteed minimum death, accumulation, income, withdrawal and withdrawal-for-life benefits (GMXBs) commonly found in variable products) ▶ Measured at fair value applying ASC 944 ▶ Changes in the fair value related to instrument-specific credit risk recognized in OCI and remaining changes recognized in income
Bifurcated embedded derivatives	<ul style="list-style-type: none"> ▶ Generally associated with benefit features offered in general account products (e.g., equity indexing features commonly found in indexed annuities and indexed universal life contracts) ▶ Measured at fair value applying ASC 815 ▶ All changes in the fair value recognized in income
Annuitization, death or other insurance benefits	<ul style="list-style-type: none"> ▶ Applied to many benefit features that do not meet the above categories, such as those protecting the death benefit of a life contract (e.g., secondary guarantees under universal life insurance policies) ▶ Valued by applying the insurance liability benefit ratio model ▶ All changes in the liability recognized in benefit expense*

* If the assessments used in calculating the liability include investment margins, a portion of the change in the liability may be recognized in OCI (i.e., shadow adjustment).

The Board noted in the Basis for Conclusions that preparers had commented on the complexity in determining which accounting model should be applied to different benefit features. The Board decided to retain the guidance on embedded derivatives in ASC 815, and,

as a result, some complexity in determining which accounting model to apply will still exist. However, the new guidance will prioritize the identification of market risk benefits within the scope hierarchy.

How we see it

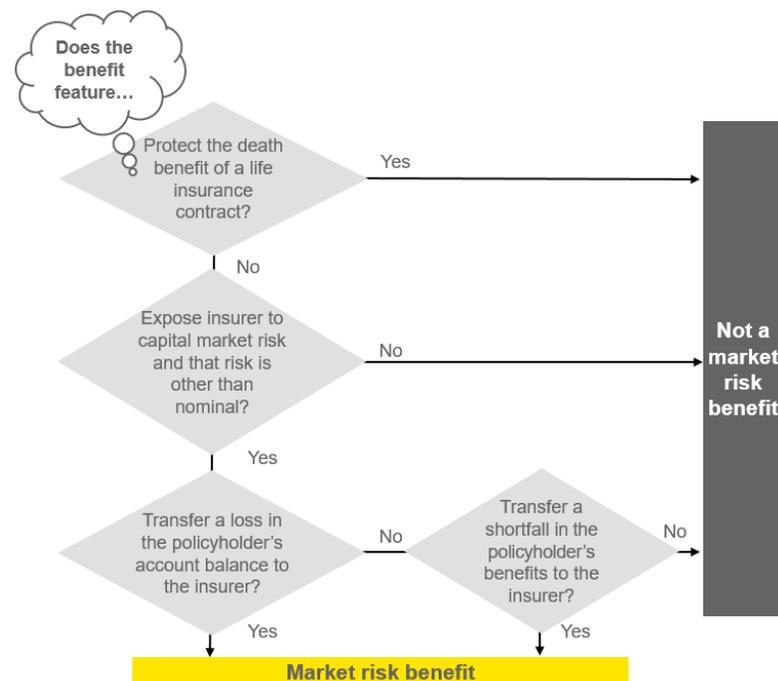
Introducing a new category of benefit features that will need to be assessed before any consideration of bifurcated embedded derivatives or additional insurance liabilities will reduce the diversity in practice in classifying and measuring certain benefit features and broaden the use of a fair value measurement model for benefit features commonly found in insurance products.

Market risk benefits – scoping

ASU 2018-12 will apply to benefit features included within either separate account products (i.e., the policyholder can direct the account funds to one or more separate account investment alternatives) or general account products (i.e., non-separate account products). In the Basis for Conclusions, the Board agreed with respondents that different measurement models for economically similar benefits, whether those benefits be offered in separate account products or general account products, would increase complexity and lead to user confusion.

ASU 2018-12 defines market risk benefits as contracts or contract features that both provide protection to the policyholder from capital market risk and expose the insurer to other-than-nominal capital market risk. Protection refers to either the transfer of a loss in, or shortfall of, the policyholder’s account balance from the holder to the insurer but does not include the death benefit component of a life insurance contract.

In the Basis for Conclusions, the Board defined capital market risk to include equity, interest rate and foreign exchange risks. Other-than-nominal exposure to capital market risk would exist if the net amount at risk (that is, the guaranteed benefit in excess of the account balance, cash value or similar amount) varies by more than an insignificant amount in response to capital market volatility, and the exposure to market risk has more than a remote probability of occurring.



The definition focuses on features that expose the insurer to a loss or a shortfall in the policyholder's account balance that would otherwise have been borne by the policyholder. A loss in the policyholder's account balance generally occurs when negative investment performance is passed through to the policyholder, but the insurer is only exposed to this loss if the contract requires the insurer to compensate the policyholder for this loss. Since the shortfall of an account value is included in the definition, benefit features that are in addition to the insurance policy benefit but do not protect the policyholder from loss of an explicit account value will also be in the scope of the definition. Features that may meet the shortfall criteria are often structured as guaranteed benefits or specified account values in reference to a target amount.

If the investments backing the liability for any features are held in a general account where investment decisions are at the discretion of the insurer and the actual performance of the general account assets is not directly passed through to the policyholder, it would be difficult to assert the contractual transfer of a loss required to meet the definition. Similarly, contracts that include specific mechanisms for periodic crediting rates (e.g., returns based on an identified index, with or without a guaranteed floor) generally will not meet the definition solely due to the crediting rates fluctuating with the capital markets.

These features define the amount to be periodically credited to (or removed from) a policyholder's account but do not require the insurer to assume a loss otherwise borne by the policyholder, or otherwise provide a benefit due to a shortfall. While any shortfall of investment returns relative to guaranteed crediting rates exposes the insurer to capital market risk, because of the defined crediting rate, the policyholder is never exposed to that capital market risk and thus the guarantee is not providing protection to the policyholder.

The guidance will exclude features that protect the death benefit of life insurance contracts (i.e., instances where the death benefit of a life insurance policy exceeds the account value). Features such as secondary guarantees on universal life insurance contracts, which are primarily designed to protect the death benefit within the life insurance contract and do not change the amount of the death benefit, will generally meet this exception. The Board clarified that this exclusion should apply only to contracts that take the legal form of life insurance. However, additional benefits could be added to the life insurance policy (e.g., withdrawal benefits), which could meet the definition of a market risk benefit since the benefits would not be protecting the contractual death benefit.

The guidance also states this exclusion should not be analogized or applied to annuity or investment contracts. In the Basis for Conclusions, the Board noted that its decision on the scope of market risk benefits focused on variability in the benefit amount (or the net amount at risk) that is influenced by capital market performance. While mortality risk is one of the inputs used to value life-contingent benefits within annuity and investment contracts, capital market performance is also an input, and as a result, the Board deemed a fair value measurement model more appropriate for these types of features. In determining the fair value of the market risk benefit, the expected timing of mortality will be included in the valuation.

The guidance creates a new category of benefit features called market risk benefits that will be measured at fair value.

Illustration 3 – Applying the market risk benefit guidance to various benefit features

The chart below illustrates potential conclusions when analyzing various contracts or contract features to apply the definition of a market risk benefit. Any capital market risk within the benefit features analyzed in this illustration is assumed to be other than nominal. Analysis and conclusions reached will vary depending on the facts and circumstances of the contracts.

Benefit feature	Does the contract or benefit feature:				Meet the definition of a market risk benefit
	Protect the death benefit of a life insurance contract	Include capital market risk	Transfer a loss	Transfer a shortfall	
Guaranteed minimum benefits (GMXBs) – guaranteed benefits including death (GMDB), accumulation (GMAB), income (GMIB) and withdrawal (GMWB)	No	Yes	Yes	Yes	Yes
Interest credited – balance is credited based on discretion of insurer or subject to a floor (e.g., guaranteed minimum interest crediting rate)	No	Yes	No	No	No
Indexed crediting rate – balance is credited with investment returns based on the greater of a selected investment performance or a guaranteed floor return (which could include a loss of principal)	No	Yes	No	No	No
Indexed crediting rate with a GMXB – beneficiary receives the higher of the current account balance or another guaranteed amount	No	Yes	No	Yes	Yes
Death benefit in a variable life contract – account balance is credited with returns from designated investment funds and the beneficiary receives greater of account balance or death benefit	Yes	N/A	N/A	N/A	No
No lapse guarantee on an insurance contract (e.g., universal life) – insurance policy is kept in force even if the account balance is not sufficient to pay the cost of insurance	Yes	N/A	N/A	N/A	No
Annuity purchase guaranty – guarantees an interest rate or guaranteed amount at the annuitization date	No	Yes	No	Yes	Yes

How we see it

- ▶ Insurers will need to establish a process for determining which guarantees qualify as market risk benefits. For guarantees that do not qualify as market risk benefits, the new guidance will not reduce the number of measurement models that can be used.
- ▶ We expect less diversity in the accounting for certain benefit features, such as guaranteed minimum benefit features (i.e., GMXBs) commonly found in variable products, since these will generally qualify as market risk benefits. As a result, benefit features measured under the benefit ratio model will be significantly reduced.
- ▶ Most periodic crediting features that are not clearly and closely related to the host debt instrument (e.g., equity-indexed annuities) will not meet the criteria for market risk benefits and will continue to be accounted for as bifurcated embedded derivatives under ASC 815.
- ▶ We would not expect the accounting to change for crediting features (such as minimum interest guarantees) that currently do not require recording of a separate bifurcated embedded derivative liability at initiation due to the crediting features being clearly and closely related to the host contract.

Market risk benefits – measurement

As previously noted, market risk benefits are measured at fair value. In the Basis for Conclusions, the FASB noted that, given the significant effect of capital market risk on the benefit payment amounts, a fair value measurement better reflects the risks inherent in the economics of market risk benefits and will provide more meaningful information to users of the financial statements than a ratable insurance accrual measurement.

In addition, the Board said preparers and users expressed concern about the accounting mismatch that arises when a market risk benefit feature that is accounted for using the insurance liability benefit ratio model (i.e., a valuation method other than fair value) is economically hedged. That is because the hedging instrument is accounted for at fair value with changes in the fair value being recognized in net income while the hedged item is not. The new guidance reduces this accounting mismatch since the market risk benefit feature (i.e., the economically hedged item) will be carried at fair value, consistent with the hedging instrument. This better aligns accounting with many insurers' risk management practices.

When determining the terms of a market risk benefit feature, insurers will be required under ASU 2018-12 to consider the guidance in ASC 815-15⁸ on determining the terms of an embedded derivative that must be accounted for separately. Insurers should use judgment at contract inception to determine the fees attributed to market risk benefits (e.g., rider fees, maintenance and expense fees) that will be compared to expected benefits for measurement purposes. However, the total attributed fees used in measurement of the market risk benefit feature should not exceed the total contract fees or assessments collectible from the policyholder and should not be negative.

Throughout the life of the market risk benefit, the feature often will be in a liability position but may be in an asset position if the present value of expected attributed fees exceeds the present value of expected benefit payments. Insurers should establish accounting policies for determining the appropriate valuation approach (i.e., non-option or option-based) for various features.

For accounting and valuation purposes, multiple market risk benefits will be bundled together as a single, compound market risk benefit.

Market risk benefits will be measured at fair value using either a non-option valuation approach or an option-based valuation approach. Day 1 measurement should not result in recognition of a gain or loss, consistent with ASC 815-15. Under the non-option approach, the fair value of the feature at contract issuance is zero. Accordingly, insurers should determine the attributed fees to be charged to the policyholder so the present value of expected fees is equal to the present value of expected benefit payments.

Under the option-based approach, the insurer first determines the fair value of the feature at contract issuance using the present value of attributed fees and the present value of expected benefits. Although the feature can have an initial fair value measurement other than zero, any potential day 1 gains or losses associated with the feature should not be recognized immediately in net income, consistent with ASC 815-15. Instead, the insurer should adjust the value of the host contract so the initial measurement of the feature and the host contract do not exceed the total fair value (i.e., initial premium or initial deposit). The discount on the host contract (i.e., the initial adjustment to the value of the host contract) may be subsequently amortized over the life of the host contract.

Multiple market risk benefits in a long-duration contract should be bundled together as a single, compound market risk benefit, consistent with ASC 815-15 requirements to combine all features that involve the same risk exposure. Previously, many benefit features were calculated separately, under different accounting models. This means the valuation model will need to utilize an integrated projection of cash flows for all applicable market benefits.

During subsequent measurement, the portion of a change in the fair value of the benefit feature in a liability position attributable to a change in the instrument-specific credit risk (i.e., the entity's own credit risk) will be recognized in OCI with the remainder of the change in fair value recognized in income. This is similar to the guidance in ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, which requires entities that adopt the fair value option for a financial instrument to separately present in OCI the portion of the total change in fair value that is caused by a change in the instrument-specific credit risk. This will result in different accounting for market risk benefit features accounted for in accordance with ASC 944 and bifurcated embedded derivatives accounted for in accordance with ASC 815-15, which does not separate the effect of a change in the instrument-specific credit risk (i.e., the entire change in the fair value of the bifurcated embedded derivative is recognized in income).

How we see it

- ▶ Measuring market risk benefits at fair value will significantly increase income statement volatility if these benefits are not economically hedged.
- ▶ Some benefit features may be measured at fair value for the first time and other benefit features within the same contract that were previously individually measured may be measured together as a compound market risk benefit.
- ▶ Insurers will need to evaluate the financial statement impact of their risk management strategies as a result of the new guidance for market risk benefits.

Annuitization, death or other insurance benefits – measurement

For contract features that neither meet the definition of a market risk benefit or a bifurcated embedded derivative, ASU 2018-12 largely retains the existing insurance liability measurement models. Insurers will continue to perform an evaluation to determine whether an additional liability is needed for the contract feature. For death or other insurance benefits, this assessment continues to be done only at contract issuance.

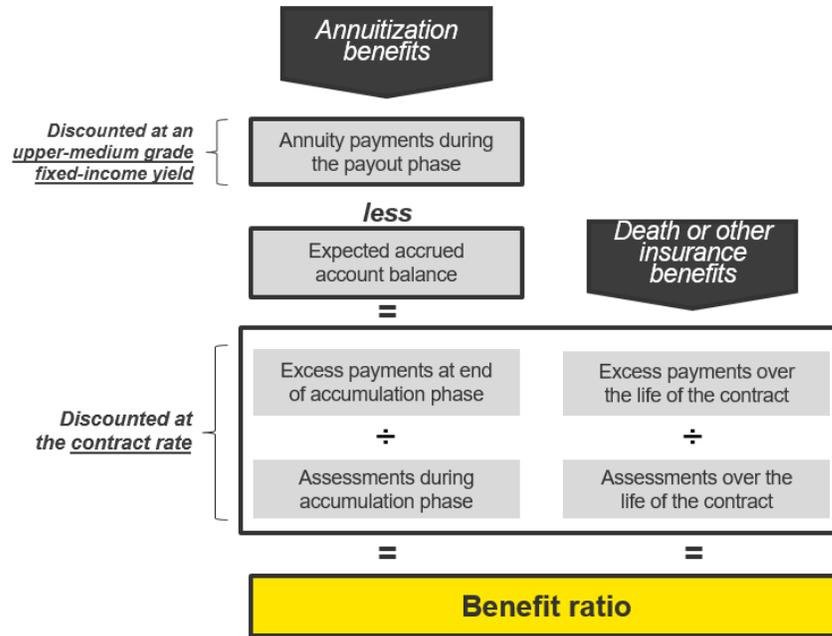
Insurers will continue to determine a benefit ratio and apply the ratio at each reporting period to cumulative assessments to measure any additional liability. However, ASU 2018-12 aligns the recognition and presentation of the remeasurement of the additional liability with that for traditional long-duration and limited-payment contracts so that the effect of changes to the benefit ratio is presented as a remeasurement gain or loss. ASU 2018-12 also changes the rate at which annuity payments expected during the payout phase are discounted to align with the upper-medium grade yield used for traditional long-duration and limited-payment contracts.

Consistent with current guidance, insurers will record an additional liability for death or other insurance benefits if amounts are assessed against a policyholder in a manner that is expected to result in profits in earlier years and subsequent losses from that insurance benefit. The liability is recognized for the portion of such assessments that, in effect, represents compensation to the insurer for services to be performed in future periods. An additional liability should be recorded for annuitization benefits if the present value of the expected annuity payments during the payout phase exceeds the expected account balance at the expected annuitization date. This provides a mechanism for establishing a liability during the accumulation phase of contracts to prevent the recognition of a loss during the payout phase as a result of the annuitization guarantee (charges for which presumably were assessed during the accumulation phase) and not to blend or smooth profits over the combination of the accumulation and payout phases.

Also consistent with today's guidance, when calculating the benefit ratio, the insurer discounts all components other than annuity payments expected during the payout phase (i.e., expected excess payments and assessments) at the contract rate. The contract rate is defined as the rate of interest that accrues to the policyholder balances, and the new guidance clarifies that the contract rate can be determined either at the contract issue date or the most recently updated date. Insurers should be consistent in applying the approach selected to determine the rate.

As previously noted, the new guidance modifies the treatment of annuity payments expected during the payout phase such that the upper-medium grade fixed-income instrument yield applicable to the payout phase of the contract (determined in the same manner as the discount rate for the liability for future policyholder benefits) will be used to calculate the present value of expected annuitization payments and related additional claim adjustment expenses. Under today's guidance, the discount rate used in these calculations is the expected investment yield. If the present value of the expected payments and expenses exceeds the expected accrued account balance at the annuitization date, the excess will be discounted at the contract rate.

To measure the additional liability, the insurer multiplies the total of the cumulative contract assessments by the benefit ratio. Contract assessments represent the compensation provided to the insurer in exchange for the insurance benefits and include all revenue expected from the contract holder from administration, mortality, expense and surrender charges, among others. For general account contracts (that is, for products in which the assets supporting the contract are reported in the general account), amounts expected to be earned from the investment of policyholder balances less amounts credited to the policyholder (i.e., expected investment margins) should be included with the total assessments considered in the calculation. For death or other insurance benefits, total assessments should also include any amortization of unearned revenue liabilities.



Because investment margins are included in an insurer’s evaluation of contract assessments, the insurer will continue to measure and record the effect that unrealized gains and losses in the asset portfolio will have on the additional liability. These effects are commonly referred to as “shadow adjustments,” and although the concept is no longer applicable to many other areas of the guidance (e.g., liability for future policyholder benefits and DAC) it remains applicable for additional liabilities that continue to consider the effect of an insurer’s investment portfolio.

Consistent with today’s guidance, for subsequent measurement insurers recalculate the benefit ratio periodically in light of emerging experience. To determine the additional liability, the insurer multiplies the cumulative assessments as they occur (i.e., actual assessments from contract inception through the balance sheet date) by the revised benefit ratio and adds accreted interest for the period. For death or other insurance benefits, cumulative excess payments are subtracted from this amount and the resulting balance is recorded as the additional liability.

As previously noted, the new guidance modifies the presentation requirements so that similar to traditional and limited-payment contracts, if the benefit ratio is subsequently revised for an additional liability, the insurer should remeasure the liability as of the beginning of the reporting period and record a remeasurement gain or loss. This remeasurement gain or loss should be reported as a separate component of benefit expense but can be included with the remeasurement gain or loss for traditional and limited-payment contracts.

How we see it

While the new guidance generally does not change the insurance liability models for the additional liabilities for annuitization, death or other benefits, it makes subtle changes that insurers should be aware of (i.e., discount rate used for excess annuity payments and presentation of a remeasurement gain or loss).

Deferred acquisition costs

ASU 2018-12 changes the amortization of DAC for traditional long-duration contracts, universal life-type insurance contracts, participating insurance contracts and investment contracts with significant surrender charges or other revenues. Investment contracts without significant surrender charges or other revenues will continue to be amortized under the effective interest method in ASC 310-20.

The new amortization approach is more consistent with how finite-lived intangible assets are amortized (i.e., if the pattern in which the economic benefits of the intangible asset are consumed cannot be reliably determined, a straight-line amortization method is used). In the Basis for Conclusions, the FASB noted that a long-duration contract is akin to a financing arrangement whereby a policyholder provides cash to an insurer that agrees to return cash to the policyholder or beneficiary at a future date. In this regard, DAC is similar to debt issuance costs, which are amortized over the borrowing term, regardless of how the borrower (i.e., the insurer) chooses to use the borrowing proceeds.

Under today's guidance, although the nature of the costs deferred is the same regardless of product type, there are different amortization models depending on product types (e.g., when the premium is recognized, or based on the pattern in which estimated gross profit (EGP) or estimated gross margin (EGM) is expected to be recognized over the life of a portfolio of contracts). Financial statement users have noted that the existing EGP and EGM amortization models are complex and require numerous inputs and assumptions that when updated result in adjustments that are challenging to understand and could result in the recovery of previously expensed DAC.

ASU 2018-12 will require insurers to amortize DAC for long-duration insurance contracts on a constant level basis over the expected life of the contracts, independent of profitability or revenue components. If DAC is grouped for measurement purposes, the unit of account (i.e., cohort) for the amortization of DAC should be the same unit of account used for the measurement of the related liability for future policyholder benefits.

Regardless of the unit of account used, the DAC amortization pattern should approximate straight-line amortization on an individual contract basis.

Issuers will need to identify attributes of the individual contracts or cohorts (independent of revenue or profitability) that provide a constant level criteria upon which the amortization may be based. The amount of insurance in force is one basis that would meet the constant level criterion. When considering various long-duration insurance product types, insurers may conclude that other attributes will accomplish the objective of ASU 2018-12. We expect insurers to consider, as applicable, insurance or benefits in force, policy count or net deposits.

Under ASU 2018-12, amortization will be required over the expected life of the contracts (i.e., all periods in which the contract is active) instead of the coverage period. In determining the expected life of the contracts, insurers will need to consider the attributes of the contracts, and in some cases, make judgments to estimate the expected life. Expected lapse rates, termination rates and mortality rates are all attributes that may be relevant to the determination, among others. Assumptions used in determining the expected life of the contract (e.g., mortality, lapse) should be consistent with those used in the measurement of the related liability for future policyholder benefits, account balance or additional liability.

In addition, for certain contracts, the determination of the expected life could include the claim payment period (e.g., disability, long-term care). However, for contracts that include accumulation and payout phases (e.g., deferred annuities), the payout phase will be considered a separate contract when determining the expected life of a contract. As a result, DAC will generally be amortized over the expected life of the accumulation phase.

DAC will be amortized on a constant level basis over the expected term of the related contracts.

Illustration 4 – Amortizing DAC using a constant level basis

Assume an insurer issues a block of five-year level term life insurance contracts in 2022 with increasing premiums and a high lapse rate at the end of the level term period. The insurer measures the reserves for future policyholder benefits at the issue year level (i.e., measures all the policies issued in 2022 together as a single cohort) and elects the amount of insurance in force as the constant level basis used to amortize deferred acquisition costs over the life of the contracts. At the beginning of 2022, the insurer defers costs totaling \$80 and estimates the amount of insurance in force over the life of the contracts.

Year	Estimated amount of insurance in force at beginning of year	Lapse (at end of year)
2022	\$ 10,000	2%
2023	9,800	2%
2024	9,604	2%
2025	9,412	2%
2026	9,224	80%
2027	1,845	10%
2028	1,660	10%
2029	1,494	10%
2030	1,345	100%
Total	\$ 54,384	

Based on the amount of insurance expected to be in force in 2022, the amortization rate is initially determined to be 18.38% (\$10,000 divided by total amount of estimated insurance in force of \$54,384). At the end of 2022, lapses are consistent with the insurer's initial estimate. As a result, the insurer measures and records amortization expense of \$14.71 for 2022 (\$80 multiplied by the 18.38% amortization rate).

At the beginning of 2023, the insurer incurs an additional \$10 of deferrable acquisition costs, resulting in a new balance of \$75.29 (\$65.29 of previous year's ending DAC balance plus \$10 in additional deferred costs).

Year	Balance, beginning of year	Capitalization	Amortization	Balance, end of year
2022	\$ -	\$ 80.00	\$ (14.71)	\$ 65.29
2023	65.29	10.00	(16.62)	58.67

This amortization process is repeated in subsequent periods, and, in this example, it will result in a change to the amortization rate due to the expected change in the amount of insurance in force. The insurer calculates the amortization rate as the period's estimate of insurance in force divided by the total expected future in force. At the start of 2023, the amount of insurance in force is \$9,800 and lapses during the year are 2%, consistent with the insurer's original estimate. As a result, the amortization rate to be applied to the unamortized DAC balance is determined to be 22.08% (the 2023 insurance in force of \$9,800 divided by total expected insurance in force over the remaining life of \$44,384). The amortization rate is then applied to the new DAC balance of \$75.29, yielding amortization expense of \$16.62 for 2023.

Changes in estimates of the selected constant level basis are reflected in the calculation of the amortization rate applied to future periods (i.e., prospective application of a change in accounting estimate). Actual experience relating to the constant level basis selected will likely differ from the experience previously estimated. Actual experience that reduces the constant level basis selected in excess of the expected reduction will result in additional expense through a write-off of DAC. Actual experience that results in the constant level basis selected being higher than expected will be recognized through a change in future amortization expense (i.e., prospective application).

Illustration 4.1 – Updates to the amortization rate

This illustration assumes the same fact pattern in Illustration 4 to demonstrate modifications to the amortization rate in periods subsequent to a contract's issuance.

At the end of 2024, the insurer experiences contract terminations of 10%, which is 8% higher than the initial expectations of 2%. The additional terminations result in the amount of in force at the end of 2024 (and beginning of 2025) being \$8,644, rather than \$9,412 as originally expected. As a result, after first recording the expected amortization, the insurer writes off deferred costs in proportion to the unexpected terminations.

Deferred costs, beginning of 2024	\$ 58.67
2024 amortization (in accordance with original amortization schedule)	<u>(16.29)</u>
Deferred costs, prior to experience adjustment	42.38
Experience adjustment (deferred cost balance of \$42.38 x 8.16%)	<u>(3.46)</u>
Deferred costs, end of 2024	\$ 38.92

The insurer calculates the experience adjustment write-off as 8.16% of deferred costs after planned amortization because the in-force amounts (after additional lapses at the end of 2024) were 8.16% less than expectations $[(9,412-8,644)/9,412 = 8.16\%]$.

The insurer next re-estimates its future terminations and adjusts its estimates of future amounts of insurance in force.

Year	Estimated amount of insurance in	
	force at beginning of year	Lapse (at end of year)
2025	\$ 8,644	10%
2026	7,780	90%
2027	778	10%
2028	700	10%
2029	630	10%
2030	567	100%
Total	\$ 19,099	

As a result of the insurer's re-estimates, the amortization rate for 2025 is revised to 45.26% (\$8,644 divided by the total amount of estimated insurance in force over the remaining duration of the life of the contracts of \$19,099). This yields amortization expense of \$17.62 (DAC balance of \$38.92 multiplied by rate of 45.26%) in 2025. Throughout the remainder of the block's life, assuming the amount of insurance in force proves to be consistent with the insurer's revised estimates, DAC-related expense for 2024 and thereafter would be as follows:

Year	Balance, beginning of year	Amortization	Experience adjustments	Balance, end of year
2024	58.67	(16.29)	(3.46)	38.92
2025	38.92	(17.62)	-	21.30
2026	21.30	(15.85)	-	5.45
2027	5.45	(1.59)	-	3.86
2028	3.86	(1.43)	-	2.43
2029	2.43	(1.28)	-	1.15
2030	1.15	(1.15)	-	-
Total		\$ (55.21)	\$ (3.46)	

The DAC amortization model will also be applied to other balances that are amortized on a basis consistent with DAC.

The FASB noted in the Basis for Conclusions that the amortization model applied using current guidance introduced uncertainty (and income variability) since it is based on long-dated and market-based (e.g., investment performance) assumptions. While the new approach under ASU 2018-12 eliminates this variability, as noted above, actual experience when compared with estimated experience is expected to affect the amortization pattern prospectively, and in some cases result in DAC write-offs.

ASU 2018-12 also clarifies or modifies guidance relating to DAC in a few areas as follows:

- ▶ Interest will not be accrued on the undiscounted balance of DAC. Because the amortization methods do not employ present value techniques and DAC is not a monetary asset, the FASB concluded interest accrual would be inappropriate.
- ▶ DAC should only include costs that have been incurred and capitalized as of the reporting date. Therefore, costs such as future contract renewal acquisition costs are not included in the amortization model until incurred.
- ▶ Assessing DAC for recoverability or impairment is not required because the FASB views DAC in a manner similar to debt issuance costs in a financing arrangement (for which there is no impairment assessment).
- ▶ The requirement to adjust DAC (e.g., when amortized using EGP or EGM) for the effect unrealized gains and losses on available-for-sale securities would have on cash flows generated by the related policies as if those gains and losses had been realized (the shadow DAC adjustment) is eliminated.

Other balances required to be amortized on a basis consistent with DAC

The simplified DAC amortization model will also affect the amortization of other balances that are amortized on a basis consistent with DAC, whether due to existing requirements in ASC 944 (e.g., deferred sales inducements or unearned revenue liabilities) or to an existing accounting policy election. Examples of balances amortized consistent with DAC as a result of an existing accounting policy election could include value of business acquired (VOBA) in a business combination or the cost of reinsurance.

The new guidance does not change the requirement to perform recoverability testing on these non-DAC balances. Examples of such balances include:

- ▶ Unearned revenue liabilities and deferred sales inducements are related to universal life-type contracts and are therefore included in the loss recognition testing of the liabilities of universal life policies (which is retained under the new guidance).
- ▶ VOBA, which is an intangible resulting from the difference between the fair value of future cash flows from contracts acquired in a business combination and the liability for policyholder benefits as of the acquisition date, is subject to impairment testing in accordance with ASC 350.⁹

How we see it

- ▶ The guidance introduces a single DAC amortization model for all long-duration contract types, with the exception of certain investment contracts, based on the concept of a constant level basis.
- ▶ Insurers will need to determine the constant level basis to be used for each type of contract, which will be independent of revenue or profit emergence.
- ▶ Under the new guidance, the amortization of acquisition expenses will no longer be aligned with the recognition of revenues, as it was previously for both traditional long-duration and nontraditional contracts.
- ▶ Eliminating the EGP and EGM DAC amortization models for universal-life type insurance contracts and investment contracts will simplify the accounting for financial statement users and reduce effort for financial statement preparers. However, this will affect the amortization pattern, which could increase income statement volatility since DAC amortization will no longer serve as an offset to movements in other liabilities such as market risk benefits or other insurance benefits.

Presentation

ASU 2018-12 will make limited changes to the current financial statement presentation, as illustrated in the following table:

	Income statement	Other comprehensive income	Statement of financial position
Reserve for future policyholder benefits	Separately present the remeasurement gain or loss (effect of updating experience and cash flow assumptions) as a component of benefit expense	Separately present the effect of updating discount rates	No change in presentation
Market risk benefits	Separately present changes in fair value other than changes attributable to instrument-specific credit risk	Separately present the portion of changes in fair value attributable to instrument-specific credit risk	Separately present the carrying amount of market risk benefit liabilities (or assets)

For the reserve for future policyholder benefits, insurers will be required to present a remeasurement gain or loss as a separate component of benefit expense during any period in which they update the net premium ratio. In the Basis for Conclusions, the FASB observed that a separate remeasurement gain or loss reflects an intuitive relationship between the remeasurement of the liability and expected future profitability. Consistent with current practice, the change in reserves during the reporting period measured using the revised net premium ratio is also reported as a component of benefit expense. Additionally, insurers will be required to separately present in OCI the effect of updating discount rates used to measure the reserve for future policyholder benefits.

The new concept of market risk benefits will require insurers to separately present the carrying amount of market risk benefit liabilities (or assets) in the statement of financial position. Similarly, the guidance will require that changes in the fair value related to the market risk benefits, other than the portion of the change attributable to a change in an instrument-specific credit risk, be presented separately in the income statement. The portion of the change in fair value attributable to instrument-specific credit risk is presented separately in OCI.

The guidance modifies the method to amortize DAC, but there are no changes to the presentation of DAC in the financial statements.

How we see it

The inclusion of a remeasurement gain or loss as a separate component of benefit expense will be a significant change from the current guidance and will result in greater transparency into the changes in reserves for future policyholder benefits. Insurers should be prepared to explain the effect of changes in assumptions to users of the financial statements.

Disclosure

The guidance will significantly expand the disclosure requirements for long-duration contracts in the annual and interim financial statements. Insurers will be required to make additional disaggregated disclosures for the insurance liabilities and DAC, including rollforwards of opening and closing balances and quantitative and qualitative information about significant inputs, judgments and assumptions used in the measurement of the liabilities and DAC.

New disclosures

The new disclosures that insurers will have to make include disaggregated tabular rollforwards of opening and closing balances of the liability for future policyholder benefits, policyholder account balances, market risk benefits, separate account assets and liabilities, and DAC. In the Basis for Conclusions, the Board stated that it made this decision because the rollforwards will provide users with information about changes in the asset or liability balances that otherwise could not be discerned solely by the fluctuation in the balances.

Insurers will also be required to provide qualitative and quantitative information about the inputs and assumptions they used to measure the balances and changes to those inputs and assumptions, among other disclosure items. The new disclosures are intended to provide financial statement users with more meaningful information to evaluate the amount, timing and uncertainty of cash flows arising from long-duration contracts. These disclosures will provide significantly more information than is currently required to be disclosed under ASC 944. Refer to Appendix B for a summary of these new disclosures.

Disaggregation principle for new disclosures

The disaggregation principle for disclosures in the guidance follows the same approach in the recent standards on short-duration insurance contract disclosures, revenue recognition, leases and credit losses. This principle provides insurers with guidelines for determining how

to disaggregate the new disclosures to give users meaningful information without requiring the inclusion of a large amount of insignificant detail or the aggregation of items with significantly different characteristics. In the Basis for Conclusions, the Board observed that useful disaggregation of information depends on the characteristics of the contracts that an insurer writes and on various entity-specific factors.

While the guidance does not specify how the insurer will disaggregate the information, the implementation guidance provides examples of categories an insurer might use, such as type of coverage or geography. An insurer should consider how information about its insurance liabilities or DAC has been disaggregated for other purposes when determining which categories would be the most relevant and useful. Some examples would include investor presentations, earnings releases, annual reports (including MD&A), statutory filings or other information used by the insurer or the users of its financial statements.

The implementation guidance clarifies that the disaggregation of the disclosures should at a minimum be consistent with segment-related disclosures. That is, if an insurer provides segment-related disclosures in its audited financial statements under ASC 280, the disaggregated categories should not include amounts of the insurance balances or DAC from different reportable segments.

After the adoption of ASU 2015-09, *Disclosures about Short-Duration Contracts*, the SEC staff issued numerous comment letters regarding the level of disaggregation with specific emphasis on disaggregating contracts with different characteristics. The staff commented that the disaggregated categories should be dynamic to mirror changes within the insurer. These lessons learned from the implementation of ASU 2015-09 could be useful as insurers implement the new disclosures required for long-duration contracts, regardless of whether the insurer is an SEC registrant.

See Appendix B for details on the disclosures that will have to be disaggregated.

Insurers will need to disclose disaggregated tabular rollforwards of insurance liabilities, DAC and market risk benefits in their interim and annual financial statements.

How we see it

- ▶ Insurers will have to capture, accumulate and evaluate on a timely basis significantly more data to comply with the additional disaggregated annual and interim disclosure requirements. An insurer may need to change its processes, systems and controls to prepare these disclosures.
- ▶ The additional disclosures will provide users of the financial statements greater transparency into the risks embedded in policies insurers underwrite and the resulting risks assumed, as well as the drivers of changes in the measurement of the liability. Because of this increased transparency, insurers should be prepared to explain their business (e.g., liability for future policyholder benefits, market risk benefits) at a more granular level.
- ▶ Insurers will need to determine the appropriate level of disaggregation for most of the new required disclosures. At a minimum, they will need to disaggregate disclosures by reportable segments, if applicable. When making this determination, management should consider whether the level at which the information is being disclosed is meaningful based on the characteristics of the insurance balance.
- ▶ Insurers should consider leveraging SEC staff observations and comments on recently issued standards when determining the appropriate level of disaggregation for the new disclosures.

Transition and effective date

The guidance is effective for public business entities for fiscal years beginning after 15 December 2020 (i.e., 2021 for calendar-year insurers) and for interim periods therein. For all other entities, the guidance is effective for annual periods beginning after 15 December 2021 (i.e., 2022 for calendar-year insurers) and interim periods within fiscal years beginning a year later. Early adoption is permitted.

The guidance prescribes the following transition approaches:

- ▶ Measurement of the liability for future policyholder benefits and DAC is required to be applied on a modified retrospective basis, with the option to elect a retrospective application.
- ▶ Measurement of market risk benefits is required to be applied retrospectively.

Regardless of the transition approach elected for the measurement of the liability for future policyholder benefits and DAC, the effect of transition will be determined at the earliest period presented (i.e., the transition date) in the financial statements in the year of adoption. For example, if the guidance is adopted in 2021 and the insurer presents three years of financial statements, the effect of transition would be applied as of 1 January 2019.

ASU 2018-12 does not provide specific transition guidance related to additional liabilities for annuitization benefits, where ASU 2018-12 modifies the discount rate used when determining the present value of expected annuitization payments for measurement purposes (see the *Annuity, death or other insurance benefits – measurement* section earlier in the publication). In the absence of specific transition guidance, insurers should apply the principles of the initial adoption of an accounting principle within ASC 250.¹⁰

Liability for future policyholder benefits

Determining the transition method

The determination of whether to apply the modified retrospective transition or elect the retrospective transition approach for the liability for future policyholder benefits should be made at the issue year level and applied entity-wide.

Insurers can elect to apply the retrospective transition method to issue years for which actual historical experience is available for all contracts throughout the entity. The earliest issue year for which actual historical experience is available for all contracts throughout the entity determines the potential retrospective adoption date. The guidance will be applied to all issue years after the retrospective adoption date. For any issue years preceding the retrospective adoption date, the insurer will apply the guidance to those contracts on a modified retrospective basis at the transition date.

In the Basis for Conclusions, the FASB recognized that actual historical information and estimates of historical experience may be unavailable (or not readily accessible), limited or insufficient because of the age of many in-force contracts. As a result, the FASB recognized that requiring full retrospective application of the guidance could be costly and impracticable and therefore decided to require a modified retrospective transition approach.

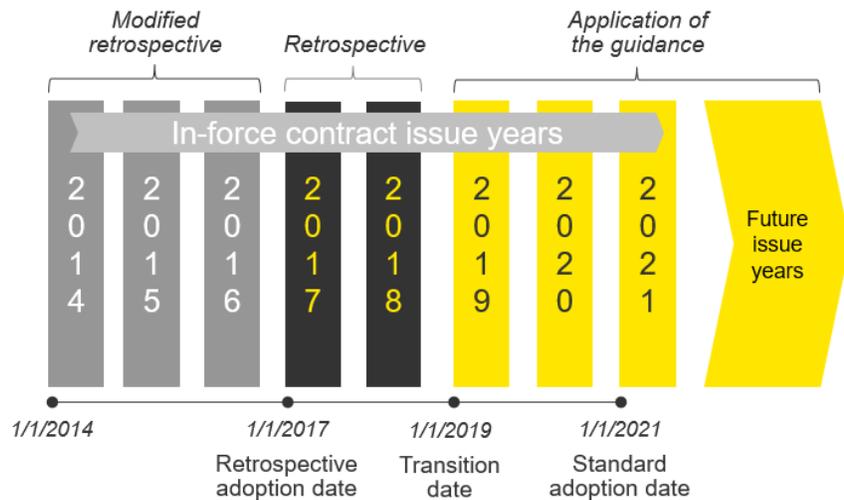
Such approach allows insurers to elect the retrospective transition method only when they have access to actual historical information from their books and records, which may include, among other things, general and subsidiary ledgers, actuarial reports, regulatory filings or other data maintained in system warehouses. Estimates of historical information may not be used.

Insurers should apply the new guidance for the liability for future policyholder benefits on a modified retrospective basis but can elect to apply it retrospectively.

Illustration 5 – Determining the transition method

This illustration demonstrates how insurers can evaluate their options for transitioning the measurement of the reserve for future policyholder benefits under the new guidance.

Assume an insurer is a calendar year-end entity and is adopting the guidance as of 1 January 2021. The insurer began writing business for three different groups of contracts in 2014 and presents three years in the income statement. Assume the insurer determines it has actual historical information back to issue year 2014 for two of the three contract groups, and only has actual historical information back to issue year 2017 for the third contract group. In this instance, the insurer can elect to apply the retrospective transition method back to issue-year 2017 (retrospective adoption date) since it is the first issue year for which actual historical information is available for all contract groups.



Under this scenario, if the insurer elects the retrospective measurement transition option, issue years 2017 and 2018 will be transitioned retrospectively. That is, the insurer will apply the guidance for the measurement of the liability for future policyholder benefits to all contracts issued in 2017 and subsequently. The insurer will then apply the guidance for issue years 2014 through 2016 on a modified retrospective basis.

How we see it

- ▶ Insurers need to establish a process to accumulate available information and determine whether that information meets the requirement for actual historical information at the level of disaggregation required. They also need to determine the extent to which this information is available on an entity-wide basis for all contract groups.
- ▶ Identifying and gathering historical information could be more challenging for insurers that operate in multiple jurisdictions, have numerous product types and in-force contracts written many years ago, and use various systems, some of which may have been changed during the life of contracts resulting in data not being retained. These and other factors may restrict an insurer's ability to elect the retrospective transition method.

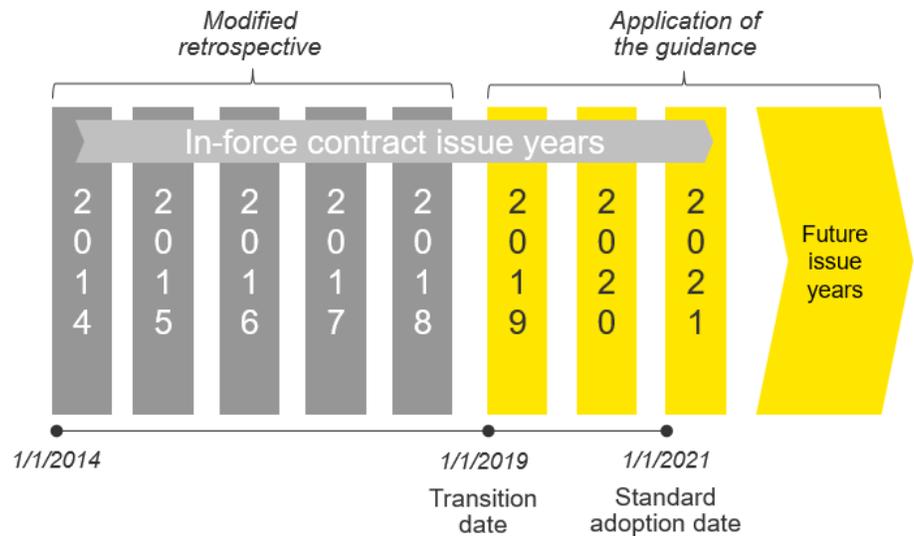
Modified retrospective transition – determining the revised net premium ratio at transition

Under the modified retrospective transition method, an insurer will apply the guidance to contracts on the basis of existing carrying values as of the transition date. That is, the opening balance at the transition date would generally be the same as the closing balance before transition, updated for the removal of any related amounts previously recorded in AOCI for items such as shadow loss reserves. The opening balance at the transition date will then be updated for the cumulative effect of changes in the discount rate between the rates applied in the measurement of the liability immediately before the transition date and the upper-medium grade fixed-income instrument yield at the transition date. This difference will be recorded in AOCI.

Illustration 5.1 – Determining the transition method: identifying modified retrospective issue years

Assume the same fact pattern as in Illustration 5, with the exception that the insurer determines not to elect the retrospective transition approach. Recall that the insurer is a calendar year-end entity and is adopting the guidance as of 1 January 2021. The insurer began writing business for three different groups of contracts in 2014 and presents three years in the income statement.

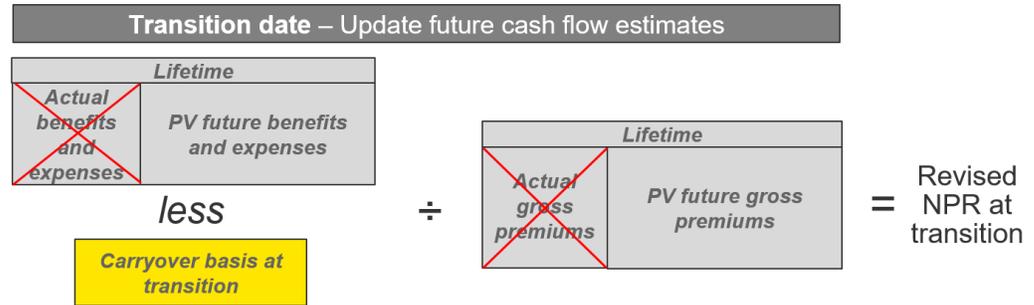
Because the insurer did not elect retrospective transition, it applies the guidance on a modified retrospective basis, under which it fully applies the guidance as of the earliest period presented in the financial statements (i.e., the transition date). As a result, the guidance for the measurement of the liability for future policyholder benefits is applied to all contracts issued in 2019 and thereafter.



The measurement of the liability for future policyholder benefits for contracts issued in 2014 through 2018 will be based on their existing carrying value as of the transition date, adjusted for the cumulative effect of changes in the discount rate between the rates applied in the measurement of the liability immediately before the transition date and the upper-medium grade fixed-income instrument yield at the transition date.

For contracts measured under the modified retrospective transition, insurers will calculate a revised net premium ratio at the cohort level using updated expected future cash flow assumptions as of the transition date less the existing carrying amount of the cohort at

transition adjusted for the removal of any related amounts in AOCI at transition (cumulatively referred to as the carryover basis). The expected future cash flow assumptions should be discounted using the discount rate used in the measurement of the liability immediately before the transition date (i.e., applying the existing guidance).



The diagram above demonstrates how the net premium ratio calculation is adjusted under a modified retrospective transition. At the transition date, an insurer only considers updated expected cash flows for future periods, adjusted for the cohort’s carryover basis at transition. The cohort’s carryover basis is the reserve balance of all contracts in the cohort at transition, adjusted for the removal of any related amounts previously recorded in AOCI.

In subsequent periods, the revised net premium ratio calculation will be based on the present value of cash flows (both actual historical cash flows and expected future cash flows) after the transition date, and the carryover basis at the transition date, which will continue to be an adjustment to the calculation for the remaining life of all contracts transitioned under the modified retrospective basis. See the *Updating of cash flow assumptions and the net premium ratio under ASU 2018-12* section for more details about the net premium ratio calculation.

Modified retrospective transition – revised net premium ratio less than 100%

When the revised net premium ratio does not exceed 100%, there is no transition adjustment other than the removal of adjustments previously recorded to AOCI and recording the effect of the upper-medium grade fixed-income instrument yield in AOCI. Any effect from updating the net premium ratio will be recognized in future periods.

The modified retrospective transition approach allows insurers to apply the guidance to contracts on the basis of their existing carrying values.

Illustration 6 – Modified retrospective transition

Assume an insurer is a calendar year-end entity that adopts the guidance as of 1 January 2021 and presents three years in the income statement. The insurer applies the new guidance beginning 1 January 2019, which is considered the transition date.

The insurer applies the modified retrospective transition approach to the liability for future policyholder benefits for contracts issued in 2017 with a 20-year term. As of 31 December 2018, the recorded liability for future policyholder benefits is \$275,000, with \$25,000 of the reserve balance being attributed to AOCI shadow reserve adjustments previously recorded.

To apply the modified retrospective measurement guidance, the insurer would first record the following journal entry at the transition date to remove the amounts previously recorded in AOCI for shadow reserves:

Dr. Liability for future policyholder benefits	\$ 25,000	
Cr. Accumulated other comprehensive income		\$ 25,000

The carryover basis at transition is now \$250,000 after the adjustment for amounts previously recorded in AOCI. The insurer then updates its cash flow assumptions as of the transition date (i.e., 1 January 2019) to determine the expected future cash flows for benefits, policy expenses and gross premiums, resulting in the following:

Undiscounted benefits and policy expenses (for years 2019-2036)	\$ 4,925,000
Undiscounted gross premiums (for years 2019-2036)	\$ 5,364,000

All cash flows are discounted with the rate used in the measurement of the liability immediately before the transition date (in accordance with the guidance existing at that time) to determine a revised net premium ratio. In this example, that discount rate was 5.5%.

Benefits and expenses (for years 2019-2036) discounted at 5.5%	(a) \$ 3,076,000
Less: Carryover basis (liability at transition after adjusting for amounts in AOCI)	<u>250,000</u>
Present value of benefits and policy expenses, less carryover basis	(b) 2,826,000
Gross premiums (for years 2019-2036) discounted at 5.5%	(c) 3,604,000
Revised net premium ratio at transition = (b) / (c)	(d) 78.4%

Because the revised net premium ratio is less than 100%, no cumulative catch-up adjustment is recorded.

The insurer also will remeasure the liability using the current upper-medium grade fixed-income instrument yield and record the difference between the remeasured liability and the carrying amount before transition to AOCI. The upper-medium grade fixed-income instrument yield at the transition date is determined to be 4%.

Benefits and expenses (for years 2019-2036) discounted at 4%	(e) \$ 3,464,000
Net premiums (for years 2019-2036) discounted at 4%	(f) <u>3,122,000</u>
Remeasured liability = (e) – (f)	(g) 342,000
Carryover basis (liability at transition after adjusting for amounts in AOCI)	(h) <u>250,000</u>
Difference = (g) – (h)	\$ 92,000

The insurer would record the following journal entry at the transition date to record the effect of the upper-medium grade fixed-income instrument yield at the transition date:

Dr. Accumulated other comprehensive income	\$ 92,000	
Cr. Liability for future policyholder benefits		\$ 92,000

Modified retrospective transition – revised net premium ratio exceeding 100%

If the revised net premium ratio at the transition date exceeds 100%, the insurer will cap the net premium ratio at 100% and increase the liability by recording a transition adjustment to the opening balance of retained earnings. To prevent a deferral of expected future losses, the liability will be remeasured as the present value of remaining expected benefits and expense amounts less the present value of remaining expected net premiums (capped at 100%). The transition adjustment is the difference between this remeasured liability and the carryover basis (i.e., existing liability excluding amounts in AOCI).

Illustration 7 – Modified retrospective transition: Revised net premium ratio exceeds 100%

Assume the same fact pattern as Illustration 6, except at the transition date the insurer's updated future cash flow expectations resulted in a revised net premium ratio of 102.2%, which means the present value of expected benefits and expenses (adjusted for the carryover basis) exceeds the present value of expected gross premiums. Thus, to prevent the deferral of expected losses to future periods, the insurer will measure the liability using the present value of expected future gross premiums (i.e., cap the net premium ratio at 100%) and determine a transition adjustment as follows:

Benefits and expenses (for years 2019-2036) discounted at 5.5%	(a)	\$ 3,933,000
Net premiums capped at 100% (for years 2019-2036) discounted at 5.5%	(b)	3,604,000
Remeasured liability = (a) – (b)	(c)	329,000
Less: Carryover basis (liability at transition after adjusting for amounts in AOCI)	(d)	250,000
Transition adjustment = (c) – (d)		\$ 79,000

The insurer would record the following journal entry at the transition date:

Dr. Retained earning	\$ 79,000	
Cr. Liability for future policyholder benefits		\$ 79,000

The insurer would then also determine the same entries shown in Illustration 6 to adjust AOCI for the updated discount rate.

Modified retrospective transition – limited-payment contracts

The modified retrospective transition for limited-payment contracts is slightly different due to the separate deferred profit liability that is recorded at contract issuance.

Consistent with the modified retrospective transition guidance for traditional long-duration contracts, the revised net premium ratio is determined at transition using the cohort's carryover basis and updated estimates of future cash flows. To the extent the liability for future policyholder benefits using the revised net premium ratio differs from the existing carrying amounts at transition, adjusted for the removal of any related amounts in AOCI at transition, the liability for future policyholder benefits should be adjusted to reflect the revised liability calculation.

This adjustment to the liability for future policyholder benefits is offset with a corresponding adjustment to the separate deferred profit liability. If the increase to the liability for future policyholder benefits exceeds the recorded deferred profit liability at transition, an immediate loss is recorded to retained earnings.

Consistent with the guidance for traditional long-duration contracts, the cumulative effect of changes in the discount rate will be recorded to the reserve for future policyholder benefits (not the deferred profit liability), with a corresponding adjustment to AOCI. The adjustment will be calculated as the difference between the rates applied in the measurement of the liability for future policyholder benefits determined immediately before the transition date and the upper-medium grade fixed-income instrument yield determined at the transition date.

Retrospective transition (all contracts)

For any issue years transitioned under the retrospective method, insurers will use actual historical information, updated expected future cash flow assumptions and an upper-medium grade fixed-income instrument yield as of the contract issue date to calculate a revised net premium ratio. The transition adjustment will equal the difference between the carrying value of the liability immediately preceding the transition date and the measurement of the liability as of that date using the revised net premium ratio.

The cumulative effect of changes in the upper-medium grade discount rates from the contract issue date to the transition date will be recorded in AOCI. To isolate and measure the discount rate effect, the insurer will perform present value calculations of projected future cash flows at the transition date using (1) the discount rate at the contract issue date and (2) the discount rate at the transition date. The difference in the two calculations will be recorded in AOCI.

Grouping of contracts at transition

When determining the level of measurement (i.e., unit of account, sometimes referred to as cohort) for the liability for future policyholder benefits, the guidance requires insurers to group contracts in force as of the transition date in a manner consistent with contracts issued subsequent to the transition date. That is, for contracts in force as of the transition date, insurers should group contracts into quarterly or annual groups on the basis of the original contract issue date.

This guidance is applicable regardless of the transition method (i.e., modified retrospective or retrospective).

How we see it

- ▶ The requirement to group all contracts into quarterly or annual groups may be a change in the level of measurement used by many insurers for contracts in force as of the transition date. This could add complexity for an insurer transitioning under the modified retrospective method, which requires the guidance to be applied to existing carrying values as of the transition date.
- ▶ Insurers transitioning under the modified retrospective method may need to establish a process to allocate recorded reserves as of the transition date among groups of contracts (i.e., cohorts) to determine the carrying values at the new level of measurement as of the transition date.
- ▶ If insurers previously aggregated contracts across issue years, at transition these contracts will need to be disaggregated at a level that is not beyond the contract issue year. The revised net premium ratios for some of the new cohorts may exceed 100% resulting in transition adjustments to retained earnings.

Earnings after the adoption of ASU 2018-12 for contracts transitioned using the modified retrospective approach

For any cohorts transitioned on a retrospective basis and for all contracts issued after the transition date, the reserve for future policyholder benefits and the profit emergence for these cohorts will be in accordance with ASU 2018-12.

In contrast, cohorts transitioned on a modified retrospective basis will realize a different profit emergence pattern over the life of cohorts due to:

- ▶ The discount rate used in the calculation of the revised net premium ratios (i.e., the interest accretion rate embedded in the net premium model that remains unchanged throughout the life of the cohort)
- ▶ The existence of a carryover basis for some cohorts, which adjusts the calculation of the revised net premium ratio

If the modified retrospective transition is applied, that rate at which interest accretes throughout the expected lifetime of the cohorts will be the rate used in the measurement of the liability immediately preceding transition, which is generally the expected investment yield at the time the contracts were issued. Under a retrospective transition and for all contracts issued subsequent to transition, that rate would be the upper-medium grade fixed-income instrument yield at the date the contracts were issued. Therefore, for many insurers the effect on the interest accretion and thus the profit emergence stemming from the variety of discount rates used in the net premium ratio calculation will continue to exist many years following the transition date.

When the modified retrospective transition approach is applied, the revised net premium ratio calculation as of the transition date and all subsequent measurement periods will include a carryover basis adjustment. Accordingly, profit emergence for those cohorts will be a blend of the recorded liability at transition and updated expectations of future cash flows over the remaining life of the cohorts.

Insurers will use the same transition approach for DAC and the liability for future policyholder benefits.

How we see it

- ▶ Profit emergence patterns will differ for cohorts transitioned under the modified retrospective transition method and those transitioned under the retrospective transition method, as well as all cohorts issued after transition. This is due to the different interest rates used in the net premium calculation and the carryover basis effect. Insurers should consider the effect on profit emergence when determining whether to elect the retrospective transition approach.
- ▶ The significance of the effect on profit emergence to cohorts transitioned under the modified retrospective method will depend on where a contract is in its expected life as of the transition date. Generally, the interest rate used in the net premium calculation will have a greater effect on cohorts in the earlier durations (i.e., earlier in the life of the contract), whereas any carryover basis will have a greater effect on cohorts in the later durations.

Deferred acquisition costs

The guidance will require insurers to align the DAC transition approach with the transition approach for the liability for future policyholder benefits. That is, for those contracts for which the insurer elects to apply a retrospective transition approach for the liability for future policyholder benefits, the insurer will apply a retrospective transition approach for the determination of the related DAC at transition. For all remaining DAC, a modified retrospective transition approach will be applied.

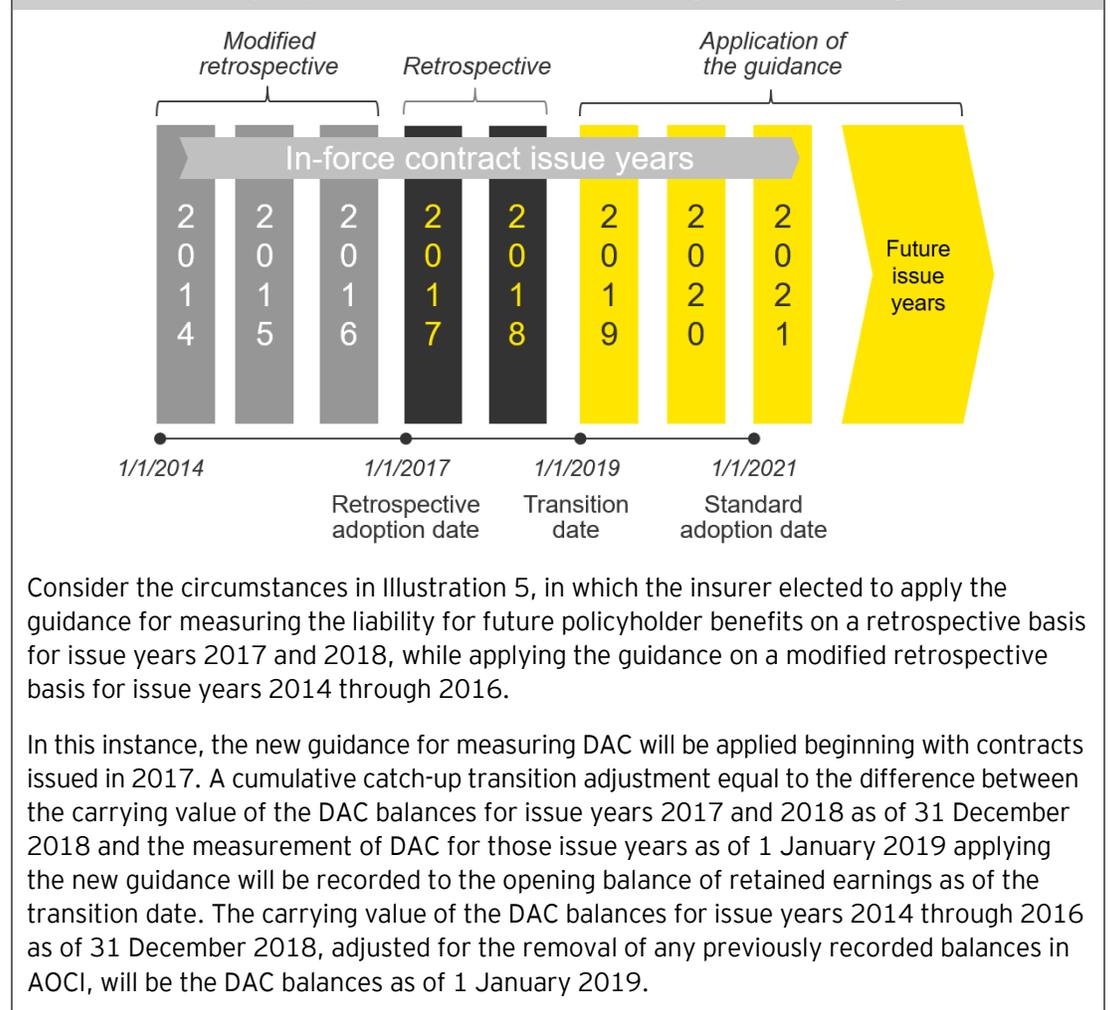
Consistent with the modified retrospective transition approach for the liability for future policyholder benefits, the opening DAC balance at the transition date will be the same as the closing balance before transition, only updated for the removal of any related amounts

previously recorded in AOCI for items such as shadow DAC adjustments. That is, DAC balances measured using current guidance will generally remain the same at transition and an insurer will only adjust its amortization methods for purposes of subsequent measurement. For example, an insurer would not adjust the opening DAC balance at the transition date for accreted interest included in the balance or a balance that was determined using EGPs before transition.

Consistent with the retrospective transition approach for the liability for future policyholder benefits, insurers will apply the DAC guidance beginning at the contract issuance date and through the transition date. Similar to the modified retrospective transition method, a transition adjustment will need to be recorded to remove any related amounts in AOCI for items such as shadow DAC. The difference between the previously recorded closing balance (after the AOCI adjustments) and the revised balance as of the transition date will be recorded as a cumulative catch-up adjustment to the opening balance of retained earnings.

The new guidance on DAC is applicable to all insurance contracts, not only those types of contracts affected by the revised liability measurement guidance in the new guidance. Therefore, DAC related to participating and nontraditional insurance contracts (i.e., universal life-type contracts) will also be subject to the transition guidance. The transition approach would follow the insurer's elected transition approach at the contract aggregation level, which may be contract issue year. That is, the modified retrospective or retrospective approach would be applied.

Illustration 8 – Aligning DAC transition with the liability for future policyholder benefits



This transition method for DAC will apply to all other balances that are amortized on a basis consistent with DAC, whether due to the existing requirements in ASC 944 (e.g., deferred sales inducements or unearned revenue liabilities) or an existing accounting policy election. Examples of balances amortized consistent with DAC as a result of an existing accounting policy election may include value of business acquired in a business combination or the cost of reinsurance.

How we see it

The effect of DAC amortization on profit emergence patterns will vary, depending on whether contracts were transitioned under the modified retrospective or retrospective transition methods. This effect will be driven by the inclusion of certain components (e.g., interest) in the DAC balance under today's guidance that will be excluded under the new guidance.

Market risk benefits

The guidance will require market risk benefits to be measured at fair value at the transition date under a full retrospective approach. This means that insurers will need to determine the valuation model (i.e., option or non-option) and the amount of attributed fees associated to the market risk benefit at contract inception as the initial steps required to measure the market risk benefit at fair value at the transition date.

In determining the fair value, insurers should maximize the use of relevant observable information for each applicable assumption as of the contract inception date. Insurers can use hindsight at transition to determine an assumption if information relevant for determining the assumption as of the contract inception date is unobservable or unavailable and cannot be independently substantiated.

In the Basis for Conclusions, the FASB noted that preparers commented that retrospective transition would be difficult due to the need to calibrate the attributed fees on an objective basis at contract inception dates under the non-option model. Therefore, the use of hindsight was provided as a practical expedient to give insurers the ability to determine attributed fees at the contract inception date, which may be many years prior to the transition date.

Changes in the instrument-specific credit risk (i.e., own credit risk) between the contract issue date and the transition date will be recognized as a cumulative effect adjustment in AOCI. All other changes between the fair value and carrying value from the contract issue date to the transition date will be recognized as an adjustment to the opening balance of retained earnings.

How we see it

- ▶ Insurers will need to apply significant judgment to assess the applicability and availability of observable data to support assumptions used in the fair value measurement of market risk benefits. We believe that insurers that previously used the fair value approach for bifurcated embedded derivatives will be less likely to use hindsight.
- ▶ We believe that an insurer's retrospective transition of market risk benefits does not affect DAC balances. That is, any change to the lifetime gross profits of a contract as a result of the guidance for market risk benefits does not affect the carrying amount of DAC at the transition date.

Insurers should apply the new guidance for market risk benefits on a retrospective basis.

Transition-related disclosures

The guidance will require insurers to disclose in the year of adoption disaggregated rollforwards for the following balances:

- ▶ Liability for future policyholder benefits
- ▶ DAC
- ▶ Balances amortized on a basis consistent with DAC that are impacted by the adoption of the new guidance
- ▶ Market risk benefits

The rollforwards should begin with the ending balance of the reporting period before the transition date and end with the opening balance at the beginning of the earliest period presented. The insurer should further disaggregate the rollforwards for any liability for future policyholder benefits and DAC balances for which it elects to apply the guidance retrospectively. Insurers are also required to disclose qualitative and quantitative information about the effect of the transition adjustments related to the opening balance of retained earnings and AOCI.

In addition, the guidance will require insurers to disclose quantitative and qualitative information regarding transition adjustments related to contracts for which the net premium ratio has been capped at 100% (i.e., when net premiums would have exceeded gross premiums)

Other matters

ASU 2018-12 retains the guidance in ASC 944 on the classification of product types (e.g., determining whether the contract is an insurance contract or an investment contract) and the classification of insurance contract types (i.e., whether an insurance contract is long duration or short duration).

The new guidance on the liability for future policyholder benefits will apply to all long-duration products measured using the net premium model, which includes products such as term life, whole life, long-term care and individual disability. It also could include group life, group disability, certain medical supplemental and certain critical illness guaranteed renewable contracts, depending on the insurer's classification of these contracts. ASU 2018-12 also retains the following aspects of current guidance:

- ▶ Measurement of liabilities carried at account balance (e.g., fixed deferred annuity, universal life, variable annuity and variable universal life)
- ▶ Performance of loss recognition testing on liabilities for universal-life type insurance contracts
- ▶ Measurement of the liability for future policyholder benefits for participating contracts
- ▶ Identification and capitalization of costs that meet the criteria to be considered acquisition costs (i.e., DAC)
- ▶ Accounting for DAC in connection with internal replacements (i.e., contract modifications or exchanges)
- ▶ Amortization of DAC for certain investment contracts that use the interest method
- ▶ Methods to recognize revenue (i.e., premiums due and amounts assessed against policyholders)
- ▶ Initial accounting for a business combination under ASC 944

However, ASU 2018-12 will indirectly change aspects of an insurer's accounting in areas where the FASB has not changed the guidance. For example, the measurement of reinsurance recoverables will change to reflect the measurement of the liabilities. That is, if the reinsurance contract is deemed to reinsure a traditional long-duration insurance contract, the reinsurance recoverable for ceded liability for future policyholder benefits will be measured under the new guidance, and changes in the recoverable related to the liability will be reported either in OCI if attributed to changes in the discount rate, or in income for all other changes. In addition, the measurement of deferred tax assets and/or liabilities will reflect the difference between the liability and DAC balances measured under this proposal and the tax-basis balances of those accounts.

Endnotes:

- ¹ ASU 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts*.
- ² ASU 2015-09, *Disclosures about Short-Duration Contracts*.
- ³ IFRS 17, *Insurance Contracts*.
- ⁴ An orderly transaction is defined in the ASC Master Glossary as "a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)."
- ⁵ ASC 820, *Fair Value Measurement*.
- ⁶ ASC 815, *Derivatives and Hedging*.
- ⁷ Statement of Position 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*.
- ⁸ ASC 815-15, *Embedded Derivatives*.
- ⁹ ASC 350, *Intangibles – Goodwill and Other*.
- ¹⁰ ASC 250, *Accounting Changes and Error Corrections*.

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Appendix A: How the new guidance compares with existing guidance

The following table compares key aspects of ASU 2018-12 with existing recognition and measurement guidance for long-duration contracts in ASC 944.

	ASU 2018-12	Existing guidance in ASC 944
	Liability for future policyholder benefits: traditional and limited-payment contracts	
Cash flow assumptions	<ul style="list-style-type: none"> ▸ Reviewed at least annually in the same period ▸ Updated through the net premium model on a cumulative catch-up basis: <ul style="list-style-type: none"> ▸ Cumulative catch-up adjustment recorded in net income ▸ Revised net premium ratio applied subsequently ▸ No provision for adverse deviation in the assumptions ▸ Option to lock in expense assumptions at contract initiation 	<ul style="list-style-type: none"> ▸ Locked in at contract initiation and held constant over the contract term, except when unlocked to recognize a premium deficiency ▸ Assumptions include a provision for adverse deviation
Discount rate assumptions	<ul style="list-style-type: none"> ▸ Based on a portfolio of upper-medium grade fixed-income instrument yields <ul style="list-style-type: none"> ▸ Reflect duration characteristics of the liability ▸ Maximize the use of observable inputs ▸ Updated every reporting period with the effect of changes recorded in OCI 	<ul style="list-style-type: none"> ▸ Based on expected investment yield at the contract issue date for most contracts ▸ Assumptions include a provision for adverse deviation
Other considerations	<ul style="list-style-type: none"> ▸ Loss recognition/premium deficiency test is eliminated ▸ Net premium ratio is capped at 100%, resulting in recognition of a loss when the cap is reached ▸ Contracts can be grouped to measure the liability but cannot include contracts from different issue years ▸ Liability at the unit of account should never be less than zero 	<ul style="list-style-type: none"> ▸ Loss recognition/premium deficiency test ▸ Measure liability at the contract level
	Participating contracts	
Terminal dividend liability	<ul style="list-style-type: none"> ▸ Accrued at a constant rate based on the present value of the basis used for the amortization of DAC 	<ul style="list-style-type: none"> ▸ Accrued over the life of the contract in proportion to the present value of the estimated gross margin expected to be realized over the life of the contract

	ASU 2018-12	Existing guidance in ASC 944
	Additional liabilities for benefit features	
Scoping	<ul style="list-style-type: none"> ▶ Benefit features meeting certain criteria are classified as market risk benefits ▶ If the benefit feature is not classified as a market risk benefit, it is first assessed to determine whether it is accounted for as an embedded derivative that requires bifurcation, and if it is not a bifurcated embedded derivative, it is accounted for under the benefit ratio model as an annuitization benefit, death benefit or other insurance benefit 	<ul style="list-style-type: none"> ▶ Benefit features may be accounted for as an embedded derivative that requires bifurcation or under the benefit ratio model, depending on the insurer's evaluation of the factors in the guidance
Market risk benefit	<ul style="list-style-type: none"> ▶ Measured at fair value ▶ May be an asset or a liability position ▶ Change in fair value attributed to instrument-specific credit risk recognized in OCI; remainder of change recognized in net income 	<ul style="list-style-type: none"> ▶ Concept of market risk benefit does not exist in today's guidance
Annuitization, death or other insurance benefits applying the insurance liability benefit ratio model	<ul style="list-style-type: none"> ▶ Expected annuitization payments discounted at upper-medium grade fixed-income instrument yields applicable to payout phase 	<ul style="list-style-type: none"> ▶ Expected annuitization payments discounted at estimated yields applicable to payout phase
	Deferred acquisition costs	
Amortization methods for all long-duration contracts (except certain investment contracts applying the interest method)	<ul style="list-style-type: none"> ▶ On a straight-line basis for individual contracts, or over the expected life of a group of contracts using a constant level basis that approximates straight-line ▶ Update amortization rate for changes in expected assumptions; apply prospectively 	<ul style="list-style-type: none"> ▶ Method varies by product (e.g., when premium is recognized or based on the pattern in which estimated gross profits or estimated gross margins are expected to be recognized over the life of a portfolio of contracts) ▶ Update amortization rate for changes in expected assumptions retrospectively for certain products or locked-in assumptions for other products
Interest	<ul style="list-style-type: none"> ▶ No interest accretion 	<ul style="list-style-type: none"> ▶ Accrued on the unamortized DAC
Impairment	<ul style="list-style-type: none"> ▶ Unexpected deviations from constant level basis result in a proportionate write-down of DAC ▶ No initial recoverability test at contract inception ▶ No impairment test 	<ul style="list-style-type: none"> ▶ Recoverability test performed at contract inception to make sure gross premiums are sufficient to cover deferred costs ▶ Assessed as part of loss recognition in subsequent periods for any potential impairment

Appendix B: New disclosures

Insurers will need to apply the disaggregation principle to many of the new required disclosures and include the new required disclosures in annual and interim financial statements.

Disaggregation principles	
<ul style="list-style-type: none"> ▶ Disclose information in a manner that allows users to understand the amount, timing and uncertainty of future cash flows arising from the liabilities ▶ Do not obscure useful information by including a large amount of insignificant detail or aggregating items that have significantly different characteristics ▶ Consider how information has been presented for other purposes ▶ Do not aggregate amounts from different reportable segments ▶ Do not make disclosures for insignificant categories except in the reconciliation 	
Disclosures	
Liability for future policyholder benefits and the additional liability for annuitization, death and other insurance benefits	<ul style="list-style-type: none"> ▶ Disaggregated rollforward of the liability balance with separate rollforwards of expected future gross premiums, expected future net premiums and expected future benefits <ul style="list-style-type: none"> ▶ Components of the rollforward may include issuances, interest accrual, net premiums collected, benefit payments, derecognition (lapses), experience adjustments, changes in cash flow assumptions and changes in discount rate assumptions ▶ For each rollforward presented: <ul style="list-style-type: none"> ▶ Undiscounted ending balance for the expected future gross premiums, expected future net premiums and expected future benefits ▶ Amount of gross premiums recognized in the statement of operations ▶ Amount of any related reinsurance recoverable ▶ Weighted-average duration of the liability and discount rate, and information about technique(s) used to determine unobservable rates ▶ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability, and total interest and gross premiums recognized for the period ▶ Qualitative and quantitative information about adverse developments resulting from when net premiums would have exceeded gross premiums in the current period ▶ On an annual basis, qualitative and quantitative information about the significant inputs, judgments and assumptions used in measuring the liability, including how they changed and the effects of the changes on the measurement of the liability
Liability for policyholder's account balances (e.g., liabilities measured at an account balance not tied to a separate account, such as universal life-type contracts)	<ul style="list-style-type: none"> ▶ Disaggregated rollforward of the liability balance <ul style="list-style-type: none"> ▶ Components of the rollforward may include issuances, premiums received, policy charges, surrenders or withdrawals, benefit payments, transfers from or to separate accounts and interest credited ▶ For each rollforward presented: <ul style="list-style-type: none"> ▶ Weighted-average crediting rate ▶ Guaranteed benefit amounts in excess of the current account balances (i.e., net amount at risk) ▶ Cash surrender value ▶ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability ▶ Tabular presentation of policyholder's account balances by range of guaranteed minimum crediting rates, and the related range of the difference between rates being credited to policyholders and the respective guaranteed minimums ▶ Qualitative and quantitative information about adverse development that resulted in a charge to current-period benefit expense as a result of premium deficiency

Disclosures	
Additional liability for market risk benefits	<ul style="list-style-type: none"> ▶ Disaggregated rollforward of the liability balance <ul style="list-style-type: none"> ▶ Components of the rollforward may include issuances, interest accrual, net assessments collected, benefit payments, derecognition (lapses), experience adjustments, changes in cash flow assumptions, changes in discount rate assumptions and changes in the instrument-specific credit risk ▶ If this rollforward achieves the fair value disclosure requirements, an insurer would not duplicate the related fair value disclosure ▶ For each rollforward presented, guaranteed benefit amounts in excess of the current account balances ▶ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability, disaggregated between positions that are in an asset position and those that are in a liability position ▶ On an annual basis, qualitative and quantitative information about the significant inputs, judgments and assumptions used in measuring the liability, including how they changed and the effects of the changes on the measurement of the liability
Separate account liabilities	<ul style="list-style-type: none"> ▶ Disaggregated rollforward of the liability balance <ul style="list-style-type: none"> ▶ Components of the rollforward may include premiums and deposits, policy charges, surrenders or withdrawals, benefit payments, investment performance, net transfers from or to separate accounts and other charges ▶ For each rollforward presented, disclose the related cash surrender values ▶ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability
Deferred acquisition costs (for all long-duration contracts) and other balances amortized on a basis consistent with deferred acquisition costs	<ul style="list-style-type: none"> ▶ Separate disaggregated rollforward of the DAC and other balances <ul style="list-style-type: none"> ▶ Components of the rollforward may include capitalization, amortization expense and termination ▶ On an annual basis, qualitative and quantitative information about inputs, judgments and assumptions, and methods used to determine amortization amounts for DAC and other balances amortized on a basis consistent with DAC