Captives with long-duration contracts

ASU 2018-12 and how it will change your financial statements

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Introduction

Those of us on the life and annuity side, were able to stand back and watch our property and casualty brethren have a challenging few years with the implementation of US GAAP Accounting Standard Update 2015-09. The FASB did not leave us out for long. The Financial Accounting Standards Board's insurance accounting overhaul, which commenced with ASU 2015-09, is now completed with the August issuance of ASU 2018-12. Early adoption of ASU 2018-12 is permitted, and for most captive entities, adoption will be required starting with reporting for calendar year 2022.

Like ASU 2015-09, these new long-duration insurance accounting changes are not specifically targeted at the captive industry. However, as captives are insurance entities, we must comply with the new standards to appropriately adhere to US GAAP. Because ASU 2015-09 only increased the disclosure requirements, and did not change the measurement of insurance accounting, we saw various applications from our captive domicile regulators upon whether they expected their captive licensees to comply, specifically in relation to the required supplementary information needs of the ASU, and the extent of that compliance.

ASU 2018-12 not only increases the disclosures around insurance liabilities and DAC (deferred acquisition costs), but also significantly changes how insurers account for long-duration contracts, including how and how frequently they measure and recognize liabilities and expenses. Because of this, it is safe to say, captive regulators will likely be more unified on how captive license holders comply with the new US GAAP standard. All life and annuity captive writers issuing US GAAP statements will be impacted.

Key accounting change No. 1:
Liability for future policyholder benefits

Today, insurers are required to base insurance liability for future policyholder benefits (in long-duration and limited-payment contracts) on assumptions that are locked in at contract inception, unless the portfolio is determined to be in a loss position. Under ASU 2018-12, insurers will now review cash flow assumptions (mortality, morbidity, terminations, etc.) at least annually in the same period each year or more frequently if there is evidence that the assumptions should be revised. They will calculate a revised net premium ratio to reflect actual experience since contract inception and updated expected cash flow assumptions. There are certain rules on application of the revised net premium ratio, outlined in the standard, including the prohibition of recognizing an asset when the present value of future net premiums exceeds future expected benefits.

Additionally, insurers will determine the rate they use to discount the liability for future policyholder benefits by using assumptions based on estimates of an "A rated" yield, rather than using the expected investment yield approach. There is now a requirement to update discount rate assumptions every quarter, recognizing the changes in discount rate through other comprehensive income.

Key accounting change No. 2:
Market risk benefits

The guidance creates a new category of benefit features called market risk benefits. Market risk benefits will provide protection to the contract holder from capital market risk and expose the insurer to other-than-nominal capital market risk. Insurers will now measure market risk benefits at fair value and present them separately in the balance sheet. Changes in fair value will be recognized separately in net income, except for changes in fair value attributable to a change in the instrument-specific credit risk. Changes attributable to credit risk will be recorded as a separate component of other comprehensive income. This differs to what we do today, where certain features that meet the definition of market risk benefits are accounted for as either embedded derivatives or insurance liabilities in accordance with the benefit ratio model.

Key accounting change No. 3:
Deferred acquisition costs

When amortizing DAC (and other balances computed under a similar model), insurers will now have to amortize on a constant-level basis over the expected life of the contract. If actual experience exceeds expected experience, a proportionate amount of DAC should be expensed. If any assumptions change, the effect must be recognized over the remaining expected life of the contract. Interest accretion, impairment analysis, and adjustments for the effect of unrealized gains and losses on available-for-sale securities (which are components of the existing DAC model), will no longer be used.

Disclosure changes

ASU 2018-12 will significantly expand disclosures over long-duration contracts, with high level correlation to the disclosure expansion promulgated by ASU 2015-09 short-duration contracts. Additional disaggregated disclosures are now required for insurance liabilities and DAC, including adding rollforwards of opening and closing balances. Disclosures will now contain quantitative and qualitative information about the significant inputs, judgments and assumptions used in the measurement of the liabilities and DAC. ASU 2018-12 establishes a principle for determining how to disaggregate the new disclosures to provide meaningful information to users of the financial statements. Unlike 2015-09, ASU 2018-12 does not have any requirements to include additional required supplementary information.

Getting prepared

As 2018-12 begins to be implemented by early adopters, keep an eye out to see how the auditors and regulators respond to the new changes. As we all begin to prepare for full adoption through 2022, I encourage you to begin asking your service providers and regulators how they view the new standard, and how they anticipate it may change your accounts, disclosures, and audit opinion.

If you are near the line on regulatory solvency requirements, the new measurements may impact your capital decisions. It may be prudent to have your actuaries run valuation estimates under the new guidance, well in advance of the required implementation date. Additionally, be mindful that you may need to request additional data from your actuaries to assist in building the new disclosures. All of this will help you be better prepared to make any necessary changes to your business plan and ensure you remain on the right side of regulatory solvency requirements.

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