MILLIMAN WHITE PAPER

Market risk benefits

What is in scope?

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The Financial Accounting Standards Board (FASB) recently approved changes to the accounting for long-duration insurance contracts, including creation of a new category of benefits called market risk benefits. This paper discusses the definition and contract features that might be within its scope.

At its meeting in early June, FASB completed its deliberations on targeted improvements for long-duration insurance contracts, marking the end of a 10-year project. FASB expects to issue the final accounting standards update (ASU) at the end of August 2018. As part of this final phase of the project, FASB has sought to address concerns raised by users of U.S. GAAP financial statements regarding the current accounting applied to guaranteed minimum benefits (GMxBs) associated with variable annuities.

The current accounting requirements contained in Accounting Standards Codification (ASC) Topic 944 provide for two measurement models for guaranteed benefit features that can result in very different patterns of earnings for the same underlying experience. FASB originally proposed a single model for accounting (fair value) for the guaranteed benefits associated with variable annuity contracts. They received feedback that similar benefit features are offered on other types of contracts including indexed and other fixed annuities and that maintaining two models for those guaranteed benefits would continue the lack of consistent measurement for similar economic features. FASB agreed and sought to develop a definition of market risk benefits (MRBs) that incorporates all such benefit features. After considering several versions of the definition and the product features that might be scoped in or out of each, FASB adopted final wording at its June 6 meeting. Measurement of MRBs will be fair value.

Market risk benefits defined

FASB has defined market risk benefits as follows:

A contract or contract feature that both provides protection to the contract holder from capital market risk and exposes the insurance entity to other-than-nominal capital market risk should be recognized as a market risk benefit.[1]

Recent and prior agenda papers have noted that only deposit- or account-value-based products are to be evaluated for the presence of market risk benefits. They provide the following considerations when evaluating whether the contract or a contract feature meets the definition:

(a) Protection refers to the transfer of a loss in (or shortfall of) the contract holder's account balance from the contract holder to the insurance entity, with such transfer exposing the insurance entity to capital market risk that would otherwise have been borne by the contract holder (or beneficiary).

(b) Protection does not include the death benefit component of a life insurance contract (that is, the difference between the death benefit amount and the accrued account value). This condition should not be analogized or otherwise applied to an annuity or investment contract.

(c) A nominal risk is a risk of insignificant amount or a risk that has a remote probability of occurring. A market risk benefit is presumed to expose the insurance entity to other-than-nominal capital market risk if the benefit would vary more than an insignificant amount in response to capital market volatility.

Consideration (a) will be the key area of interpretation for insurers as considerations (b) and (c) seem relatively straightforward. Specifically, insurers will need to consider the following questions:

- Was a loss (or shortfall) in the account balance due to capital market risk transferred?
- Does the transfer expose the insurer to capital market risk?
- Would the transferred capital market risk have been borne by the contract holder (or beneficiary)?

Analysis of product considerations

LOSS OF ACCOUNT VALUE VERSUS SHORTFALL

FASB's first consideration effectively equates a shortfall in account value with a loss of account value. These are very different criteria. With today's products, a loss in account value only takes place when the investment performance is passed through to the policyholder and the investment performance can be negative. A shortfall in account value needs to be determined in reference to a target account value. A loss in account value is not required in order to have a shortfall. The account value just needs to be less than the target. A shortfall in account value could exist due to the presence of guarantees as to minimum return or minimum specified level of account balance.

[1] FASB (June 6, 2018). Board Meeting Handout Insurance: Targeted Improvements to the Accounting for Long-Duration Contracts, p. 6, paragraph 30.

Many account-value-based products have minimum credit rate guarantees. Those products often have guaranteed minimum death and living benefits with roll-up types of guaranteed benefits that act similarly to minimum credit rate guarantees. From prior discussions with FASB members and staff we believe that it was not FASB's intent to include minimum interest rate guarantees within the scope of market risk benefits. However, if it is deemed that roll-up type benefits on contracts that cannot lose account value do meet the definition of market risk benefits, it would seem that minimum credited rate guarantees would also be in scope unless the wording of the final standard specifically scopes them out.

CAPITAL MARKET RISK

Once a loss or shortfall is determined to be possible, the insurer will need to determine if it was due to the presence of capital market risk. FASB has stated in several of its proposals that capital market risk includes equity, interest rate, and foreign exchange risk.

For variable products where the underlying account value is typically invested in a series of mutual funds and the performance of those funds directly affects the level of account value, capital market risk would be seen to be present. The contract holder would bear the risk of capital market risk directly in that person's account balance and the provision of a minimum death or living benefit at a specified level irrespective of the account value would effectively transfer the capital market risk to the insurer for that benefit feature.

Insurers often provide guarantees on general account products. These include minimum credit rates, minimum death benefits, and minimum living benefit guarantees. Insurers have significant discretion in setting credit rates on fixed deferred annuities. There is no contractual tie between the credit rate and capital market performance. While it is common practice for insurers to invest the funds backing the account value of fixed annuities in fixed income investments and thus expose the insurer to interest rate risk, the actual performance of those assets is not directly passed through to the account value. The insurer declares the credit rate in advance. Thus, it would seem more difficult to assert that any shortfall in credit rates was due to the presence of capital market risk on these products. If capital market risk is difficult to assess, then any other guarantee offered on such products would also be difficult to define as a market risk benefit. The presence of minimum credit rate guarantees provides a floor on the account value, effectively preventing a loss from occurring. The distinction between a potential loss in account value versus a shortfall in account value may also be important in evaluating these types of products.

Fixed indexed annuities (FIAs) are typically offered with guaranteed minimum benefits that pay out in the event of death, maturity, conversion to a payout annuity, similar to the types of minimum guaranteed benefits that are commonly available on variable deferred annuities. These guarantees would effectively transfer the capital market risk to the insurer for those benefit features. However, unlike variable annuities fixed indexed annuities typically cannot lose account value due to capital market movements. Therefore the meaning of shortfall in account value in the final definition will be relevant to whether the GMxBs on FIAs are market risk benefits and thus must be fair valued.

A more recent version of the indexed annuity is the registered indexed annuity. In these products the account value is at risk for loss due to capital market movements and a portion of that risk is transferred to the insurance company through the contract features. GMxBs offered on these types of products would appear to fit the definition of market risk benefits.

Based on current information we summarize in Figure 1 our view on the major deferred annuity product forms as to whether they fit the definition of MRB. We assume in our analysis that minimum return type guarantees do not meet the definition of MRB.

FIGURE 1: ANNUITY PRODUCT SUMMARY

BASE CONTRACT	MEETS MRB DEFINITION
VARIABLE ANNUITY	YES
FIXED ANNUITY	NO
FIXED INDEXED ANNUITY	NO
REGISTERED INDEXED ANNUITY	YES

Conclusion

FASB has concluded its work on the targeted changes, but uncertainty remains regarding the applicability of some of the decisions made. The scope of MRBs is a key area of uncertainty. There may be some clarity provided when the final ASU is released at the end of August. It is also possible that further guidance will be necessary. In any event a thorough review of the considerations that apply will need to be performed for each product type.

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