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Four Regulatory & Accounting Updates: What Life/Annuity & Health Insurers Need to Know

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Insurers are facing a number of proposed and pending regulatory and accounting changes. Life/annuity and health companies are most likely to feel an impact.

The changes are intended to help improve transparency, clarify operating rules and enhance customer protections. However, the new rules will likely add to business complexity and could impact volatility in investment performance and earnings.

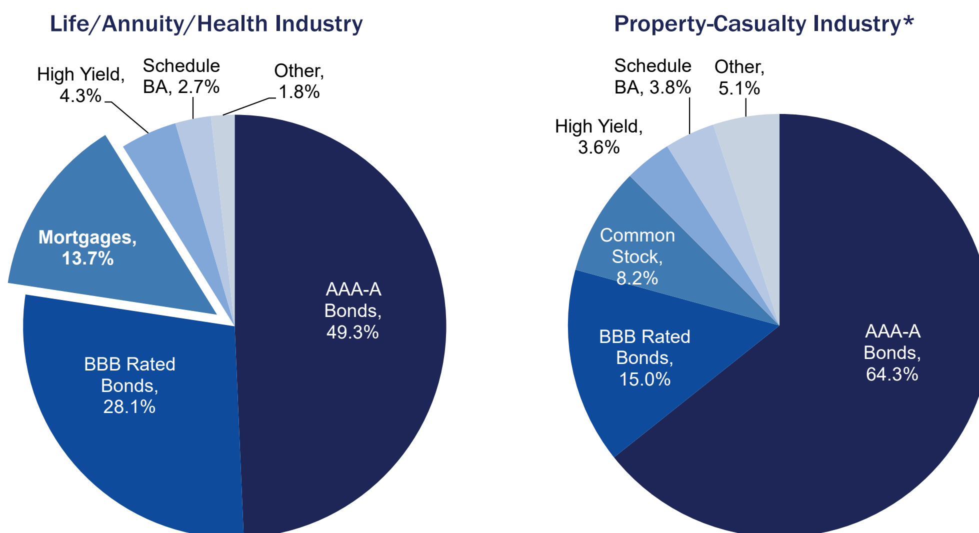
Conning offers insights on four of the major updates: accounting for current expected credit losses (CECL), financial reporting for long-duration contracts, new fiduciary rules, and principles-based reserving (PBR).

1) CECL: Identifying Credit Events Sooner

The 2008-9 financial crisis led the Financial Accounting Standards Board (FASB) to require that financial institutions recognize expected credit losses sooner. A 2016 Accounting Standards Update (ASU) included a new methodology for GAAP filers to identify CECL. It's a methodology that statutory filers should be aware of as well.

The methodology doesn't prescribe a specific approach for determining expected credit losses for assets held at amortized cost, but the requirement is expected to have significant impact.

Figure 1 - Comparison of 2018 Investment Portfolios by Industry



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For example, recognizing expected credit losses at origination of commercial mortgages, a key life insurance asset class, may affect investment strategy and change the timing for recognition of investment returns. (Assets held as "available for sale" are recorded at fair value, and thus the measurement method for credit losses does not change from the prior standard.)

While initial measurements of CECLs may be minimal in a benign economic environment, a more volatile environment would likely require expected credit losses to be recognized much earlier. Greater management judgment will also be required to estimate credit losses, which could add to volatility.

However, the new standard could also benefit insurers by requiring earlier identification of assets at risk, possibly reducing instances of sudden recognition of asset credit deterioration. And unlike asset write-downs, CECL allowances can rise or fall.

The new approach highlights differences between GAAP and statutory accounting, and the NAIC may look to similar approaches in the future. The insurance industry has argued against these sorts of approaches in statutory accounting, noting that life insurers already have reserves against credit-related losses via the asset valuation reserve and credit-risk charges in risk-based capital. Life companies are also more susceptible to CECL requirements given their higher percentage of illiquid investments, including a higher exposure to mortgages (see Figure 1) and bonds of longer duration on average.

The standard takes effect for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Other public business entities will have an additional year for implementation. All other entities, including employee benefit plans covered by FASB topics on plan accounting, will have an effective date of December 15, 2022.

2) Long-Duration ASU: Adding Transparency and Complexity

Another FASB ASU established in 2018 intends to improve financial reporting for long-duration insurance contracts, which tend to cover life/annuity insurance products. However, the proposed changes may make life insurer earnings more volatile by establishing ongoing valuations for a number of items that previously were not updated post contract issuance, and also establishing rules for more consistent valuations across the industry.

Among the steps in the long-duration ASU:

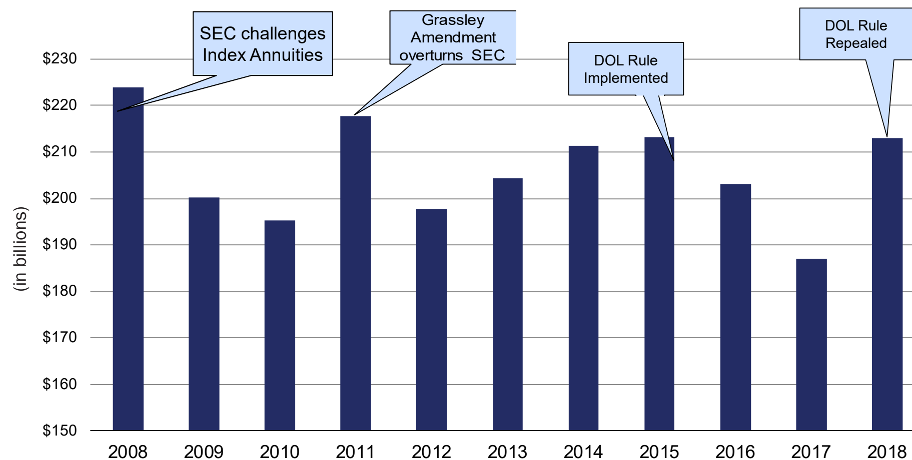
- A requirement to unlock liability valuation assumptions at least once a year; previously they were often locked in at policy issuance and never updated.
- A determination of a standardized valuation rate based on market-observable interest rates and yields; previously valuation rates were locked in at inception for many life products and often varied by company. (The effect of changing rates will be recorded in "other comprehensive income.")
- A fair value measurement of embedded financial guarantees, to be more closely linked to derivatives' measurement approaches.
- A simplified amortization of deferred acquisition costs.
- A requirement for additional disclosures, such as rollforwards, significant valuation assumptions, and the effect of changes in those assumptions.

The ASU will be effective for calendar-year public companies at the beginning of 2022, with an effective date of beginning of 2024 for other calendar-year companies. There will be a one-time adjustment reported when the new standard goes into effect, with an option to develop the effect retrospectively.

3) Reg BI: May Hamper Annuity, Life Sales

Fiduciary regulations at both the federal and state levels may impact annuity and life insurance sales in 2020. At the federal level, the Department of Labor (DOL) and the Securities and Exchange Commission (SEC) have been developing new fiduciary standards for financial advisors. The uncertainty caused by the introduction of the DOL's

Figure 2 - Regulatory Changes & Impact on Annuity Sales, 2008-2017



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2016 version contributed to a significant decrease in annuity sales (see Figure 2). The September 2019 appointment of Eugene Scalia as Secretary of Labor delayed the deadline for a revised proposal, with no new deadline set as of March 1, 2020.

The SEC issued a final rule on its "Regulation Best Interest: The Broker-Dealer Standard of Conduct," known as "Reg BI." The regulation does not have a uniform fiduciary standard for both investment advisers and broker-dealers, which resulted in some confusion and criticism. In September 2019, a coalition of attorneys general from seven states plus the District of Columbia challenged Reg BI in federal court.

Even before the SEC adopted Reg BI in June 2019, multiple states were working toward imposing fiduciary duties and increased disclosure requirements on broker-dealers.

Among state efforts, New York's Regulation 187, which sets a best-interest standard for annuity and life insurance sales, could have the greatest impact. Just weeks after the annuity standards took effect in August 2019, Jackson National suspended the sale of fee-based annuities in New York and Penn Mutual suspended all annuity applications. The life insurance standards took effect February 1, 2020.

4) NAIC's Principle-Based Reserving: Now Live in Statutory Accounting

The NAIC's PBR completed its three-year transition period for state regulators and insurers on January 1, 2020.

Some of the key provisions and effects:

- Insurers may optionally adopt the use of the 2017 CSO (Commissioners Standard Ordinary) mortality table for statutory valuation, even if they are not immediately fully implementing PBR. The new mortality table was expected to greatly reduce statutory reserves for some life product designs.
- Actuarial Guideline 48 requires the use of the 2017 CSO table in determining the net premium reserve (NPR) for covered business.
- There are exclusion tests that many standard life insurance designs will likely pass so that full stochastic modeling, for example, will not be needed, a welcome relief to the complexity that faced mid-size insurers
- Companies without products with material secondary guarantees being sold, and with premium of covered products below $300 million for the operating company and $600 million for the insurer group, are exempt from PBR implementation. (This company-wide exemption need not be communicated until the transition period is over in 2020.)

Reinsurance is often used for life insurance to reduce surplus strain for the direct writers due to a great difference between statutory and GAAP reserves. While in-force business will not see statutory reserving relief, possible lower reserving requirements for new business may reduce the use of third-party indemnity reinsurance as well as the use of captives.

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