Working Draft

Targeted Improvements to Long-Duration Contracts Implementation Paper

Issue #3: **Market Risk Benefits – Scope.**

Wording to be Included in the Audit and Accounting Guide: Life and Health Insurance Entities.

Market Risk Benefits

1. As discussed in FASB ASC 944-40-25-25B, at inception of a universal life-type or investment contract (as per ASC 944-40-15-6), an insurance entity should first determine if a contract or contract feature that provides for potential benefits in addition to the account balance should be accounted for as a market risk benefit, and, if not, whether the benefit should be accounted for as a derivative or as an annuitization, death or other insurance benefit.

2. As stated in FASB ASC 944-40-25-25C, "A contract or contract feature that both provides protection to the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk shall be recognized as a market risk benefit."

3. FASB ASC 944-40-25-25D states:

> In evaluating whether a contract or contract feature meets the conditions in paragraph 944-40-25-25C, an insurance entity shall consider that:
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> a. Protection refers to the transfer of a loss in, or shortfall (that is, the difference between the account balance and the benefit amount) 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).
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> b. Protection does not include the death benefit component of a life insurance contract (that is, the difference between the account balance and the death benefit amount). This condition does not apply to an investment contract or an annuity contract (including an annuity contract classified as an insurance contract).
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> c. A nominal risk, as explained in paragraph 944-20-15-21, 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.

4. FASB ASC 944-40-55-29A and 55-29B provide examples of guaranteed minimum accumulation or death benefits that meet the criteria for a market risk benefit as defined in FASB ASC 944-40-25-25C:

A contract holder deposits $100,000 in a deferred annuity (either fixed or variable) that provides for a guaranteed minimum accumulation benefit that guarantees that at a specified anniversary date (for example, 5 years) the contract holder's account balance will be the greater of the following:

a. The account value
b. Deposits less partial withdrawals accumulated at 3 percent interest compounded annually.

The contract holder's account balance is exposed to stock market performance. At the specified anniversary date the contract holder's account balance has declined to $80,000 due to stock market declines. The guaranteed minimum value of the $100,000 deposit compounded annually at 3 percent interest is $115,930. The contract holder's account balance will be increased to the greater amount, resulting in an account balance of $115,930. In this Example, the guaranteed minimum accumulation benefit meets the criteria for a market risk benefit in accordance with paragraph 944-40-25-25C because the guaranteed minimum accumulation benefit protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk. Specifically, the insurance entity compensates the contract holder for the shortfall (due to stock market declines) between the account balance amount of $80,000 and the guaranteed amount of $115,930. The guaranteed minimum accumulation benefit should be measured at fair value in accordance with paragraph 944-40-30-19C. Similarly, if on the date of the death of the contract holder the deferred annuity provides a guaranteed minimum death benefit amount of $115,930 while the account balance is $80,000, the guaranteed minimum death benefit meets the criteria for a market risk benefit in accordance with paragraph 944-40-25-25C because the insurance entity provides compensation for the shortfall (due to stock market declines) between the account balance amount of $80,000 and the guaranteed amount of $115,930.

5. FASB ASC 944-40-55-29C and 55-29D provide examples of guaranteed minimum living benefits that meet the criteria for a market risk benefit as defined in FASB ASC 944-40-25-25C:

A contract holder deposits $100,000 in a deferred annuity (either fixed or variable) that provides a guaranteed minimum income benefit. The contract specifies that if the contract holder elects to annuitize, the amount available to annuitize will be the higher of the then account balance or the sum of deposits less withdrawals. The contract holder's account balance is exposed to stock market performance. At the date that the contract holder chooses to annuitize, the account balance has declined to $80,000 due to stock market declines.

In this Example, the guaranteed minimum income benefit meets the criteria for a market risk benefit in accordance with paragraph 944-40-25-25C because the guaranteed minimum income benefit protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk. Specifically, the insurance entity compensates the contract holder for the shortfall (due to stock market declines) between the account balance amount of $80,000 and the $100,000 guaranteed amount at the annuitization date. During the accumulation phase, the guaranteed minimum income benefit feature should be measured at fair value in accordance with paragraph 944-40-30-19C. Similarly, if the deferred annuity provides a guaranteed minimum withdrawal benefit or a guaranteed minimum lifetime withdrawal benefit that protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk, the guaranteed minimum withdrawal benefit or the guaranteed minimum lifetime withdrawal benefit meets the criteria for a market risk benefit.

6. FASB ASC 944-30-55-58 provides an example of a contract modification for the exchange of a single premium deferred annuity for an equity-indexed annuity, including describing both contracts, and states:

> A single premium deferred annuity has a crediting rate that is set at the discretion of the insurance entity. An equity-indexed annuity is a deferred fixed annuity contract with a guaranteed minimum crediting rate plus a contingent return based on a contractually specified internal or external equity index. Equity-indexed annuities typically are classified as investment contracts with embedded derivatives that are required to be bifurcated from the contract and accounted for separately under Topic 815-10. Topic 815 (see paragraphs 815-15-55-62 through 55-72). Generally, the equity index feature represents a periodic crediting rate mechanism that affects the amounts credited to the contract holder's account balance, rather than representing a benefit in addition to the account balance that protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk. Periodic crediting rate mechanisms are required to be evaluated for possible bifurcation under Topic 815. However, an equity-indexed annuity also may contain one or more market risk benefits (see paragraphs 944-40-55-29A through 55-29D).

7. FASB ASC 944-30-55-76 provides an example of the exchange of a variable annuity for a variable annuity with guaranteed minimum withdrawal benefits, and states, in part: "A variable annuity with a guaranteed minimum withdrawal benefit is classified as an investment contract with a market risk benefit…"

8. FASB ASC 815-15-55-58 addresses payment alternatives for variable annuity contracts when applying the embedded derivative bifurcation criteria, and states:

> During the accumulation phase of a deferred annuity contract, a guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize does not require separate accounting under paragraph 815-15-25-1 because the criterion in paragraph 815-15-25-1(c) is not met. The embedded option does not meet the definition of a derivative instrument because it does not meet the net settlement criteria as discussed beginning in paragraph 815-10-15-99. Settlement of the option can be achieved only by an investment of the account balance in a payout annuity contract in lieu of electing an immediate payment of the account value. If an additional provision existed whereby the policyholder could withdraw all or a portion of its account balance during the payout phase, an embedded derivative would still not exist because the economic benefit of the guaranteed minimum interest rate would be obtainable only if an entity were to maintain the annuity contract through its specified maturity date. However, the embedded option may be considered a market risk benefit (see paragraph 944-40-25-25C).

9. When evaluating whether a contract or contract feature meets the definition of a market risk benefit in FASB ASC 944-40-25-25C, the insurance entity considers the guidance in FASB ASC 944-40-25-25D. As such, the insurance entity evaluates whether a potential benefit is provided in addition to the account balance that is not the death benefit component of a life insurance contract (i.e. the difference between the account balance and the death benefit amount). FinREC believes that the consideration of the guidance in FASB ASC 944-40-25-25D requires judgement in determining if:

    a. a contract or contract feature that exposes the insurance entity to capital market risk causes variability of the potential benefit amount as compared to the account balance. As discussed in BC 71 in the "Basis for Conclusions" section of ASU No. 2018-12, capital market risk includes equity, interest rate and foreign exchange risk. FinREC believes that exposure to capital market risk can exist whether the interest crediting rate is contractually specified or discretionary.

b. capital market risk is other-than-nominal, including the evaluation of whether the benefit would vary more than an insignificant amount in response to capital market volatility.

10. As noted in FASB ASC 944-40-25-25D(c), 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. In making this determination, FinREC believes an entity should consider a range of capital market risk scenarios, which may exclude capital market risk scenarios that have a remote probability of occurring. If an entity determines that a contract or contract feature has nominal capital market risk, thereby excluding it from the scope of the market risk benefit guidance, FinREC believes that the capital market risk for that same contract or contract feature will also be considered nominal under ASC 944-20-15-21 and thereby the contract or contract feature will not be subject to the additional benefits guidance in paragraphs 944-40-25-26 through 25-27A.

11. Further, FinREC believes the analysis of whether exposure to capital market risk is other-than-nominal should be performed without considering the likelihood of expected contract holder utilization of the contract feature.

12. FinREC believes that the likelihood of death is not relevant in the scope assessment for a death benefit contract feature. Therefore, for death benefit guarantees that expose the insurance entity to capital market risk, FinREC believes the FASB ASC 944-40-25-25D analysis should be performed as if the contract holder's beneficiary were to receive the death benefit (i.e. what is the death benefit being provided under the contract, not the measurement value to the reporting entity).

13. FinREC believes that the likelihood of annuitization (contract holder utilization) is not relevant in the scope assessment for an annuitization guarantee contract feature. However, FinREC believes that mortality assumptions are relevant to the contract holder when quantifying his/her potential life contingent benefit and, therefore, are relevant in the scope assessment. For an annuitization guarantee that exposes the insurance entity to capital market risk, FinREC believes that the FASB ASC 944-40-25-25D analysis should be performed as if the contract holder were to elect to annuitize and consider mortality assumptions (i.e. what is the benefit being provided under the contract, not the measurement value to the reporting entity).

14. FinREC believes that the disability and health insurance benefit features (e.g. long-term care) of a universal life-type contract (whether designed as a universal disability or health contract or as a rider to a universal life insurance contract) are subject to the exception in FASB ASC 944-40-25-25D(b) and, therefore, do not meet the definition of a market risk benefit. In evaluating whether a contract or contract feature meets the conditions in FASB ASC 944-40-25-25C, FASB ASC 944-40-25-25D(b) does not explicitly include or exclude disability or health insurance benefit features of a universal life-type contract from the death benefit exception. However, FASB ASC 944-40-25-25D(b) does state that protection "does not include the death benefit of a life insurance contract (that is, the difference between the account balance and the death benefit amount)" and explicitly states that this "condition does not apply to an investment contract or an annuity contract (including an annuity contract classified as an insurance contract)." Further, FASB ASC 944-20-15-12 states

that “if insurance contracts have characteristics significant to” those of universal life-type contracts then they “are within the scope of the Long-Duration Contracts Subsections of [FASB ASC Topic 944]. For example, universal disability contracts that have many of the same characteristics as universal life-type contracts, with the exception of providing disability benefits instead of life insurance benefits, shall be accounted for in a manner consistent with universal life-type contracts.”

15. The following are indicators that a contract or contract feature may meet the criteria in FASB ASC 944-40-25-25C and 25-25D for a market risk benefit:

    a. The receipt of the higher of the account value or a minimum guaranteed amount or the withdrawal of a specified amount for the lifetime of the contract holder, including amounts that are specified as a percentage of the account value at the time the guaranteed withdrawal option is exercised. Examples include a: guaranteed minimum death benefit (FASB ASC 944-40-55-29B); guaranteed minimum income benefit (FASB ASC 944-40-55-29C – 29D); guaranteed minimum accumulation benefit (FASB ASC 944-40-55-29A – 29B); and guaranteed minimum withdrawal benefit or guaranteed minimum lifetime withdrawal benefit (FASB ASC 944-40-55-29D and 944-30-55-76).
    b. An annuitization guarantee of the interest rate or of the annuitization amount (FASB ASC 815-15-55-58).

16. FinREC believes that the following are indicators that a contract or contract feature may not meet the criteria in FASB ASC 944-40-25-25C and 25-25D for a market risk benefit:

    a. An annuitization guarantee of the mortality charge or table because the contract holder is not protected from capital market risk.
    b. An interest crediting rate feature that affects the amounts credited to the contract holder’s account balance because it does not represent a benefit in addition to the account balance and, therefore, does not protect the contract holder from capital market risk - e.g., a minimum crediting rate on a fixed annuity or the equity index feature on an equity-indexed annuity.

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