Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue: Grade in of Variable Annuity Reserves**

**Check (applicable entity):**

P/C Life Health

Modification of Existing SSAP

New Issue or SSAP

Interpretation

Description of Issue:

At the 2019 Summer National Meeting, the NAIC Executive and Plenary adopted revisions drafted by the Life Actuarial (A) Task Force to Section 21 of the *Valuation Manual* *Requirements for Principle-Based Reserves for Variable Annuities (VM-21)* which provides comprehensive updates to the Commissioners Annuity Reserve Valuation Method of reserving for variable annuities. The revisions adopted to VM-21 represent an accounting change that must be recognized as a change in valuation basis under *SSAP No. 51R—Life Contracts.* Updates to SSAP No. 51R are needed to coordinate with the recent revisions to the variable annuity reserving methodology. In addition, the proposed revisions recommend deferring to VM-21 regarding future variable annuity reserving methodology phase-ins along with disclosure on phase in details.

The enhancements to the variable annuity framework resulting in revisions to AG 43 and VM-21 centered around the following:

* Reforming the standard scenario to enhance regulatory oversight of companies’ actuarial assumptions
* Mitigating asset-liability accounting mismatch between hedge instruments and statutory liabilities
* Improving interpretability of framework results and simplicity of calculations
* Facilitating greater harmonization across insurers and products for greater comparability

To achieve this focus the determination of the Conditional Tail Expectation (CTE) amount, Standard Scenario and the Standard Scenario amount has changed significantly resulting in the revised variable annuity reserves methodology.

The revisions to VM-21 in combination with the revisions to Actuarial Guideline XLIII CARVM For Variable Annuities (AG 43) applies retroactively to contracts issued between 1981 and Dec. 31, 2019 as follows:

* VM-21 changes affect reserving for contracts issued Jan. 1, 2017 through Dec. 31, 2019
* AG 43 changes affect reserving for contracts issued to 1981 through Dec. 31, 2016

These changes to the variable annuity reserving framework updated the principles and methodology and apply retroactively (see Authoritative Literature). Under SSAP No. 55 a change in valuation basis is recognized as a change in surplus rather than an increase in reserves recognized through income.

The VM-21 allows the following choices for phasing in the change in reserving valuation basis necessitated by variable annuity reserving methodology changes. Early adoption, beginning Dec. 31, 2019

* Adoption in full beginning Jan.1, 2020
* A reporting entity election to grade in over 3 years.
* An election to grade in over 7 years, subject to commissioner discretion.

In addition, it provides the following acceleration provisions:

* Early termination and full recognition,
* If there is a material decrease in the book of business by sale or reinsurance ceded, the company shall adjust the amount of the grade-in provision. The grade-in amount (C = R1 R2, as described below) must be scaled down in proportion to the reduction in the excess reserve, measured on the effective transaction date as the reserve amount in excess of cash surrender value before and after the impact of the transaction.
* The company must obtain approval for any other modification of the remaining grade-in amount.

Existing Authoritative Literature:

Valuation Manual – Section 21

Effective Date and Phase-In These requirements apply for valuation dates on or after Jan. 1, 2020. A company may elect to phase in these requirements over a 36-month period beginning Jan. 1, 2020. A company may elect a longer phase-in period, up to seven years, with approval of the domiciliary commissioner. The election of whether to phase in and the period of phase-in must be made prior to the Dec. 31, 2020, valuation. At the company’s option, a phase-in may be terminated prior to the originally elected end of the phase-in period; the reserve would then be equal to the unadjusted reserve calculated according to the requirements of VM-21 applicable for valuation dates on or after Jan. 1, 2020. If there is a material decrease in the book of business by sale or reinsurance ceded, the company shall adjust the amount of the phase-in provision. The phase-in amount (C = R1 – R2, as described below) must be scaled down in proportion to the reduction in the excess reserve, measured on the effective transaction date as the reserve amount in excess of cash surrender value before and after the impact of the transaction. The company must obtain approval for any other modification of the remaining phase-in amount. The method to be used for the phase-in calculation is as follows:

***SSAP No. 51R—Life Contracts***

**Change In Valuation Basis**

36.          A change in valuation basis for reserves determined under paragraphs 18-21, except for reserves defined under Actuarial Guideline XLIII—CARVM: For Variable Annuities (AG 43), as detailed in Appendix C of this Manual, shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3).

37.          Changes in reserves developed under paragraph 22 or AG 43 shall be reviewed to determine whether the change represents a change in valuation basis and if it meets the definition of a change in accounting as defined in SSAP No. 3.

a.         Changes in principle-based reserving assumptions are often the result of updating assumptions and other factors required by the existing reserving methodology. Reserve changes resulting from the application of principle-based reserving methodology including, but not limited to, updating assumptions based on reporting entity, industry or other experience, and having the reported reserve transition between net premium reserve, deterministic reserve or stochastic reserve, as required under existing guidance, shall not be considered a change in valuation basis. These types of changes also include, but are not limited to, periodic updates in Valuation Manual tables, such as industry valuation basic tables, asset spread tables and default cost tables.

b.          A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed or the insurer makes a voluntary decision to choose one allowable reserving method over another. These types of changes include, but are not limited to, new standardized mortality tables such as Commissioners Standard Ordinary tables and regulatory changes in methodology.

38.          Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus (under changes to surplus in the change in valuation basis annual statement line) rather than as a part of the reserve change recognized in the summary of operations.

39.          The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement prescribes a new method and a specific transition that allows for grading. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. The Valuation Manual is effective prospectively for policies written on or after the operative date. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

*SSAP No. 3—Accounting Changes and Corrections of Errors*

**Disclosures**

13. Disclosure of material changes in accounting and correction of errors shall include:

a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material; and

d. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

14. Refer to the Preamble for further discussion regarding disclosure requirements.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS): Not applicable**

Staff Review Completed by:

Robin Marcotte, **NAIC Staff - November 2019**

Staff Recommendation:

# NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose the revisions described and illustrated below to *SSAP No. 51R—Life Contracts*, and adding reference to the additional grade-in disclosure requirements in *SSAP No. 3—Accounting Changes and Corrections of Errors* for reporting years beginning Jan. 1, 2020. In addition, NAIC staff plans a future agenda item regarding exercise of Commissioner Discretion in the VM. Proposed revisions detailed in the current agenda item:

1. Revises the existing guidance, which prohibits grading-in changes in valuation basis unless provided for in the statement, to allow a grade-in for changes in valuation basis if permitted by the statement or the *Valuation Manual* in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21). Historically choosing effective dates for major reserving changes for the *Accounting Practices and Procedures Manual* has been determined by Working Group, for example the 2001 CSO table (adopted in 2002) was effective for policies January 1, 2004 in Appendix A-820. This has been to promote consistent implementation and reporting. By deferring to the VM-21 on grade-in options with many varied features, there will be less comparability in reporting, because there is more optionality in reserve reporting. Therefore, additional disclosure regarding grade-in has been proposed.
2. A change in valuation basis under SSAP No. 51R is recognized through surplus. As the unrecognized graded-in reserve represents an unrecognized adjustment to surplus, the revisions require the unrecognized grade-in amount from a change in valuation basis, if resulting with an increase in reserves (decrease from surplus), to be reported as an allocation from unassigned funds to special surplus until the amount has been fully graded into unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus. This is to provide transparency regarding the increased reserve amount that has not been reflected into surplus. As amounts are graded-in to reduce surplus, the amount in special surplus is reclassified to unassigned funds.
3. The proposed revisions to SSAP No. 51R expand the disclosure for changes in valuation basis as a change in accounting principle under SSAP No. 3 to also include details regarding grade-ins of changes in valuation basis, including the grade-in period applied, the remaining amount to be graded-in, remaining time for the grade-in period and the initial grade-in amount and any adjustments to the original amount.
4. Adds a reference in SSAP No. 3 regarding additional disclosures of grade-in features.

NAIC staff plans to propose a new agenda item to address commissioner discretion in the VM. The exercise of commissioner discretion has been typically removed from Appendix A – Excerpts of Model Laws so that if it is exercised, it is disclosed as a permitted or prescribed difference in Note 1 to provide transparency and comparability. As the *Valuation Manual* incorporates Commissioner discretion that might not be reported as a prescribed or permitted practice, NAIC staff also recommends a future agenda item, regarding how to provide transparency on the use of commissioner discretion.

**SSAP No. 51R:**

**Change In Valuation Basis**

36.          A change in valuation basis for reserves determined under paragraphs 18-21, except for reserves defined under Actuarial Guideline XLIII—CARVM: For Variable Annuities (AG 43), as detailed in Appendix C of this Manual, shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3)*.

37.          Changes in reserves developed under paragraph 22 or AG 43 shall be reviewed to determine whether the change represents a change in valuation basis and if it meets the definition of a change in accounting as defined in SSAP No. 3.

a.          Changes in principle-based reserving assumptions are often the result of updating assumptions and other factors required by the existing reserving methodology. Reserve changes resulting from the application of principle-based reserving methodology including, but not limited to, updating assumptions based on reporting entity, industry or other experience, and having the reported reserve transition between net premium reserve, deterministic reserve or stochastic reserve, as required under existing guidance, shall not be considered a change in valuation basis. These types of changes also include, but are not limited to, periodic updates in *Valuation Manual* tables, such as industry valuation basic tables, asset spread tables and default cost tables.

b.          A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed, or the insurer makes a voluntary decision to choose one allowable reserving method over another. These types of changes include, but are not limited to, new standardized mortality tables such as Commissioners Standard Ordinary tables and regulatory changes in methodology.

38.          Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus (under changes to surplus in the change in valuation basis annual statement line) rather than as a part of the reserve change recognized in the summary of operations.

39.          The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement or the *Valuation Manual* in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. If the grading permitted by this statement or *Valuation Manual* section VM-21 represents an increase in the reserve liabilities, the unrecognized change in valuation basis reserve increase shall initially be reflected as an allocation from unassigned funds to special surplus until fully recognized in reserving and unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus, but highlights the ungraded in amount for transparency as it represents an unrecognized adjustment (decrease) to total surplus. The allocation to special surplus is reversed to unassigned funds as the grading of the increase in reserving is recognized as a decrease to total surplus. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the *Valuation Manual* section VM-21 (on variable annuities) or this statement prescribes or permits a grading in period or provides the option of multiple grading periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

1. the grade in period being applied, and the remaining time period of the grade in
2. any adjustments to the grade in period.
3. amount of change in valuation basis grade in, which has been recognized in unassigned funds and
4. the remaining amount to be graded-in (reflected in special surplus if the ungraded in amount represents an increase in reserving).

40. The Valuation Manual is effective prospectively for policies written on or after the operative date, however, as the CARVM methodology was already principles based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and to the related AG 43 may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus will be zero. After initial adoption of the *Valuation Manual*, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

***SSAP No. 3—Accounting Changes and Corrections of Errors***

**Disclosures**

13. Disclosure of material changes in accounting and correction of errors shall include:

1. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;
2. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and
3. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material;
4. Changes in accounting that are changes in reserve valuation basis as described in *SSAP No. 51R—Life Contracts* which have grade in or other optional application features, shall also include in the change in accounting disclosures information regarding the application of any grade in as provided for in SSAP No. 51R. and
5. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

**Status:**

On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 51R—Life Contracts* and *SSAP No. 3—Accounting Changes and Corrections of Errors* as illustrated above. The revisions add reference, disclosures and accounting for Section 21 of the *Valuation Manual*, Requirements for Principle-Based Reserves for Variable Annuities, and grade-in requirements for reporting changes in the valuation basis for years beginning January 1, 2020.

**For 2020 Spring National Meeting Discussion,**

**NAIC Staff recommends that the Working Group adopt the exposed revisions, incorporating interested parties proposed edits of removing the reclassification to special surplus as summarized and illustrated in the agenda item and below. The proposed text for adoption does not incorporate all of the interested parties’ revisions. If preferred, the Working Group could have a short re-exposure, but such a deferral may raise first quarter reporting concerns.**

**NAIC Staff does not propose to incorporate the following revisions requested by Interested Parties:**

* SSAP No. 51, paragraph 39, 40 and SSAP No. 3 - Keep the exposed grade in guidance as which defers only to the VM 21 CARVM grade in guidance and requires coordination on future VM grade in proposals.
* SSAP No. 51, paragraph 40 – did not add industry proposed language on retroactivity.

**NAIC Staff illustration incorporates the following revisions requested by Interested Parties:**

* SSAP No. 51, paragraph 39 and subparagraphs c and d – Delete the exposed reclassification to special surplus until the grade in for reserving amount is fully recognized. Most entities will have a short-term impact (three years) and disclosure should be adequate.
* SSAP No. 51, paragraph 39/40 – Maintain the existing language on changes in accounting in paragraph 39 instead of moving it paragraph 40 as proposed in the exposure.
* SSAP No. 51, paragraph subparagraphs and SSAP No. 3 – editorial - Change “grade-in” to “phase in” as suggested by interested parties to maintain consistency with SSAP No. 51 and the Valuation Manual.

**Note that Shaded revisions are edits to prior exposure**

**SSAP No. 51R**

39.          The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be phased in over time unless this statement or the *Valuation Manual* in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the *Valuation Manual* section VM-21 (on variable annuities) or this statement prescribes or permits a phase in period or provides the option of multiple phase in periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

1. the phase in period being applied, and the remaining time period of the phase in
2. any adjustments to the phase in period.
3. amount of change in valuation basis phase in, and
4. the remaining amount to be phased-in.

40. The Valuation Manual is effective prospectively for policies written on or after the operative date, however, as the CARVM methodology was already principles based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and to the related AG 43 may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus for most entities will be zero. After initial adoption of the *Valuation Manual*, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

***SSAP No. 3—Accounting Changes and Corrections of Errors***

13d. Changes in accounting that are changes in reserve valuation basis as described in *SSAP No. 51R—Life Contracts* which have elected phase in provided for in the *Valuation Manual* Section VM 21, shall also include in the change in accounting disclosures information regarding the application of any phase in as provided for in SSAP No. 51R. and

**“Clean version” of revisions tracked only to SSAP 51R and SSAP No. 3 with shading new wording**

**SSAP No. 51R**

39.          The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be phased in over time unless this statement or the *Valuation Manual* in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the *Valuation Manual* section VM-21 (on variable annuities) or this statement prescribes or permits a phase in period or provides the option of multiple phase-in periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

1. the phase in period being applied, and the remaining time period of the phase in
2. any adjustments to the phase in period.
3. amount of change in valuation basis phase in, and
4. the remaining amount to be phased-in.

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***SSAP No. 3—Accounting Changes and Corrections of Errors***

**Disclosures**

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1. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;
2. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and
3. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material;
4. Changes in accounting that are changes in reserve valuation basis as described in *SSAP No. 51R—Life Contracts* which have elected phase in provided for in the *Valuation Manual* Section VM 21, shall also include in the change in accounting disclosures information regarding the application of any phase in as provided for in SSAP No. 51R. and
5. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

On March 18, 2020, the Statutory Accounting Principles (E) Working Group exposed this agenda item, with revisions as illustrated above under “Spring National Meeting Discussion.” A referral will also be sent to the Life Actuarial (A) Task Force for notification of this exposure. This item has a shortened comment period deadline ending May 1, 2020.

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