



The road ahead on Targeted Improvements to the Accounting for Long-Duration Contracts

Lessons learned and mobilization efforts

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts* (LDTI), which amends the accounting model under US GAAP for certain long-duration insurance contracts. The ASU seeks to improve the existing measurement, presentation, and disclosure requirements for long-duration contracts issued by an insurance company.

We have been actively engaged with the industry to prepare for this change since the proposal for the standard was published in August 2018 and have closely followed the development of ASU 2018-12. Our dialogue with standard setters, leadership of industry

roundtables, relationships with technology vendors, and engagement with insurers that have begun their program mobilization have taught us much about early LDTI successes and challenges. This paper offers observations and early lessons learned and discusses the steps an insurer should consider as it embarks on the path to a successful LDTI implementation.

Contents

How insurers are mobilizing their implementation programs.....	2
Next steps	10

How insurers are mobilizing their implementation programs

The new standard will impact virtually every actuarial balance insurers carry, including actual vs. expected experience, transactional data, all reserves, deferred acquisition cost (DAC), and account values. As a result, the company's end-to-end process—from data origination through reporting—will likely require a multifaceted transformation. Major efforts will be required from accounting and finance, actuarial, technology, and project management departments to help ensure a successful transition. In addition, functions such as product development and pricing, forecasting, risk management, tax, legal, internal audit, investments, financial planning, procurement, human resources, and investor relations will have a critical role.

Given the extensive scope of these changes, we are finding that insurers, consultants, and vendors are capacity constrained, as marketplace demand for these skills exceeds the supply. Meaningful resource commitments will therefore be necessary across the organization to achieve compliance.

Program alignment is the critical first step in a project of this magnitude. To achieve the expected results, organizations should treat this as a large-scale change by establishing a robust plan that highlights key timelines, internal and external stakeholders, and interdependencies to allow them to manage the various projects that will comprise the overall implementation program. Additionally, having a strong governance structure will facilitate effective decision making and balance competing priorities. By taking time to form a team at the beginning that is responsible for promoting consensus, minimizing issues, and collaborating quickly without compromising completeness, leaders can reduce the time spent identifying gaps and determining a path forward.

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Evaluating the current landscape

As insurers look to develop their roadmaps for LDTI compliance, they should consider the following topics:

Discount rate

- Can the current valuation system discount cash flows under multiple FASB TI-appropriate discount rates or yield curve?
- Does the current actuarial valuation system have the capability to store historical and current discount rates, including yield curves or single equivalent yields, as appropriate?

Best-estimate assumptions

- Is the historical data available at the proper cohort level to determine the best-estimate cash flows?
- Are assumptions developed that will support the FASB TI disclosure and reporting requirements' required granularity?

Benefit reserves/deferred profit liability

- Does the valuation system support an unlockable FPB and DPL, as needed?
- Is historical cash flow data available, which is necessary for the recalculation of the net premium ratios? Is the data collection automated?

Deferred acquisition costs/unearned revenue/sales inducement assets

- Does the data exist and is the valuation system able to determine the deferred acquisition costs (DAC), unearned revenue (UREV), sales inducement assets (SIA) on a cohort level or a seriatim level?
- Does the valuation system support an unlockable DAC, UREV, or SIA and adjustments for historical experience?

Market risk benefits

- Are significant changes needed to existing processes/systems to transition market risk benefits (MRBs) reserves to fair-value calculations (e.g., if previously under SOP03-1, etc.)?
- Is historical data available to recalculate MRB h-ratios? Can historical risk-neutral scenarios be generated or are they still available?

Loss recognition testing (LRT)

- Which products have suffered from a loss recognition event?
- At what level of granularity is the GPV liability available? At what level of granularity is the shadow GPV liability available?

Reinsurance

- Does the company currently report any reinsurance on a deposit accounting basis (assumed or ceded)? If so, what system is used to value reinsurance balances and does this support FASB TI?
- Can seriatim data, necessary for valuation, be accessed for assumed reinsurance business? Are best-estimate cash flows available for assumed reinsurance business?

Transition

- How are current valuation systems utilized? What is being calculated in Excel?
- What are the manual procedures in the data flow process (e.g., from administrative system to database to reserve calculation engine, and ultimately booked into the general ledger)?
- To the extent the company utilizes a third-party administrator (TPA) to house its administrative data, is historical data available at the proper level of granularity for adjustments for actual experience? How much data manipulation is needed prior to feeding the valuation systems?

As insurers work through their implementation plans, a key step is identifying the strategic decisions that will drive their programs. We have seen the following common decision points emerge as insurers consider their implementation programs:

- **Target architecture:** A foundational step in developing an implementation plan is to define the organization's target LDTI architecture. This should include a holistic mapping of the technology and underlying data flows that are needed to extract and transform the required data for consumability, to model and calculate LDTI results, and to produce the corresponding reports and disclosures. The target architecture should also be designed to incorporate (or ideally eliminate) manual adjustments in the valuation process in a controlled manner. This will allow final balances to be retained within the valuation environment and enable systems to be effectively leveraged in the disclosure process.
- **Smart compliance:** Many insurers are viewing LDTI as a catalyst to transform their technology and infrastructure as part of an enterprise modernization initiative. However, full modernization will likely be unfeasible for many insurers prior to the standard's effective date. Some incremental process and technology enhancements may therefore be needed to achieve minimum viable compliance, which will lower implementation costs but may raise business-as-usual costs. Smart LDTI compliance seeks the optimal trade-off between achieving minimum compliance and a desired level of sustainable future efficiencies given the entity's time and resource constraints. To facilitate a smart compliance implementation, insurers should evaluate their current framework for capability gaps and then balance the cost and timeline implications to realize maximum value from their implementation efforts.

- **Reinsurance/TPA solutions:** The reports many companies receive from reinsurers and third-party administrators (TPAs) can vary significantly in quality, granularity, and timeliness. We are also seeing instances where insurers receive reserves directly from the reinsurers/TPAs and have no current-state modeling or reserve processes in place. Given the volume of changes required by the standard on some of these blocks, management will need to coordinate with external data providers to determine whether they will receive LDTI reserves, inclusive of all required attribution and disclosure information, or will instead develop data storage and calculation solutions in-house to achieve compliance with the standard. In instances where the required historical data is unavailable in a timely manner or modification to administrative systems are needed, some insurers are developing allocation methods to best project the actual data.
 - **Hedging impacts:** Under LDTI, many organizations are anticipating a shift in their earnings and equity volatility. These changes may cause organizations to reevaluate prospective hedging strategies and implement changes to better match the expected earnings patterns of the underlying insurance blocks.
 - **Transition method election:** Under LDTI, market risk benefits (MRBs) accounting is required to be applied retrospectively to all prior periods. However, the ASU permits insurers to elect either a retrospective or modified retrospective adoption of the standard when transitioning DAC and the liability for future policy benefits related to nonparticipating traditional and limited-payment insurance contracts. Companies may want to evaluate the availability and granularity of historical data and assumptions, model availability and integrity, historical GAAP events (e.g., LRT, PFBL, business combinations, etc.), and other operational considerations when determining their transition method election. In turn, that election could ultimately drive downstream impacts on the overall implementation roadmap, timeline, and requirements.
 - **Interplay between ASU 2018-12 and other regulatory changes:** Companies required to comply with IFRS 17 and/or that are moving toward principle-based reserving for statutory-basis financial statements may wish to consider leveraging possible overlaps with LDTI. While IFRS 17 and LDTI will likely require separate modeling modules, decisions about vendor selection and software integration should contemplate the holistic changes insurers will face, so that multiple reserving platforms are not required to support the standards. In addition, both the IFRS 17 and LDTI standards are adopted retrospectively and require an intense review of historical policy and loss data. Some of the work done around historical data, analysis, assessment, cleaning, and review of issued policies can likely be leveraged across the implementation of the regulatory changes. Lastly, the target operating model updates that reflect the changes to the reserve, finance, and reporting processes can be designed to meet the requirements of the new standards, and the accounting and actuarial policies and methodologies for these updates can be designed concurrently.
- Many insurers are developing timelines and high-level project plans that extend beyond the effective date of ASU 2018-12, in addition to those focused on achieving compliance within a two- to three-year window. Due to the short timeline for implementation and the breadth of the prescribed changes, we are seeing many insurers' plans call for short-term solutions that will enable LDTI reporting. Organizations are therefore looking to modernize some of these minimum compliance-oriented efforts to achieve additional long-term efficiencies and develop an effective future-state operating model. Of course, deferring any transformative aspects of the ASU adoption has the risk that those initiatives remain part of the company's strategic priorities further out in the future.

There are additional potential risks to consider as companies establish a project plan. With the final standard only issued on August 15, 2018, industry interpretation of the standards continues to evolve. Working assumptions need to be developed and should consider the potential for different interpretations within the business plan. The new changes bring an opportunity to modernize certain operational aspects; however, care should be taken to ensure these opportunities do not put compliance with the standard at risk. In addition, an effective governance framework needs to be established to balance competing priorities and make effective decisions on the project's execution and requirements. Insufficient resources present another challenge in implementing the new ASU, so it is critical to mobilize resources with knowledge over data, systems, processes, and methodologies. Lastly, any documentation on existing methodologies, data, systems, and processes will need to be updated to reflect the updates.



Through our roundtables, discussions, and initial assessments we have become familiar with the issues that insurers are wrestling with, which are largely centered around technical accounting and methodology, technology, and data considerations.

Technical accounting and methodology

From a technical standpoint, insurers continue to be challenged with operationalizing certain technical provisions of the standard—particularly around contract grouping, accounting for contracts with long-tail claim reserves, and the identification and treatment of market risk benefits. While industry views are beginning to coalesce around some topics, others may require additional clarification from standard-setting bodies to reach consensus.

Many insurers are grappling with their approach to **contract grouping**, debating whether to calculate amortization on a seriatim- or cohort-level basis. The LDTI’s constant-level DAC, SIA, and unearned revenue reserve (URR) amortization methodology is intended to serve as a simplification of the multiple disparate concepts that have been historically applied. The ASU does not explicitly state the level of aggregation an insurer should apply when determining their DAC amortization, but it does specify two critical requirements: insurers should amortize DAC on contract groups “on a constant-level basis that approximates straight-line amortization on an individual contract basis,”¹ and “contracts shall be grouped consistent with the grouping used in estimating the liability for future policy benefits (or any other related balance) for the corresponding contracts.”² DAC may be easier to calculate on a seriatim basis, though insurers seem to be trending toward issue-year-based cohorts for benefit reserves to address the interaction between insurance company pricing and new benefit reserve requirements related to zero reserves and net premium ratio capping at 100 percent.

Another point of frequent discussion relates to the **treatment of claim reserves** (i.e., disabled life reserves) for long-tail contracts, such as disability and long-term care. Questions mainly arise from how insurers should adjust for updates to the contracts’ net premium ratios, apply discount rates, and consider the claim period when determining the DAC amortization term. Ultimately, the industry may seek further clarification on how best to approach these issues before reaching a conclusion on a valuation approach.

Early implementation observations

Lessons learned

During the initial phase of assessments, we have seen insurers challenged in the following areas:

Technical accounting

- Should contracts be grouped on a seriatim- or cohort-level basis when calculating the NPR?
- How to account for riders and add-on coverage to in-force contracts?

Methodologies

- For long-tail contracts (e.g., disability and long-term care), how should insurers apply discount rates and adjust for updates to the net premium ratio? How should the DAC amortization term be defined?
- How should the scope of market risk benefits be defined? How should hindsight be interpreted at transition for MRBs?

Technology

- Do existing technology platforms need enhancement, replacement, or complete overhaul?
- What actuarial and finance IT vendors offer the right synergies for the company’s objectives?

Data

- What is the availability of historical data? How will that data be collected, and where will it be maintained on an ongoing basis?
- What do the future disclosure templates look like, and what information should be captured?

Determining an approach for the treatment of **market risk benefits** is another area of complexity. A significant point of discussion relates to how the scope of MRBs should be defined. Ultimately, the key lies in the structure of the benefit and the level of protection, whereby an MRB transfers other-than-nominal risk of losses or shortfalls in the account value, relative to the benefit, to an insurance entity. This provision applies to annuities (whether classified as life insurance under US GAAP or not), but not life insurance products. That said, certain gray areas exist in this definition, with uncertainty around the classification of products such as annuity purchase guarantees, certain fixed indexed annuities, and benefit-responsive GICs. While some are beginning to develop positions on the classification of these products, industrywide consensus has not yet been solidified. If deemed MRBs, models and methods will need to be developed and integrated with existing guaranteed minimum benefits (GMxB). This may require significantly more work than needed for compliance of annuities valued under SOP03-1, where existing models can largely be adapted to conform to the MRB fair-value basis calculation. Nonetheless, the question of the MRB scope remains another topic where insurers may seek additional clarification from regulators.

A related topic is the **use of hindsight at transition for MRBs** when retrospectively valuing the benefits. The ASU permits hindsight to determine measurement assumptions if those assumptions “are unobservable or otherwise unavailable and cannot be independently substantiated.”³ This means that hindsight cannot be the default approach used in this retrospective valuation at transition. Given limited data availability, many companies will need to apply judgment when assessing the applicability and availability of observable data to support their historical MRB assumptions, especially on older historical periods.

Technology

LDTI does not have a “one size fits all” solution. Off-the-shelf technology solutions do not exist across all elements of insurers’ LDTI architectures, and historically many insurers struggled to quickly build in-house tools that could stand up to audit-like scrutiny. However, leveraging prior investments in finance and actuarial technology will allow insurers to maximize the value extracted from this new vendor technology.

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To enable smooth LDTI processes, vendors have been developing updates to existing **actuarial platforms** that specifically address the methodology changes prescribed by the standard. Where possible, insurers are generally planning to utilize vendor system enhancements as a foundation of their implementation, often selecting a preferred vendor as a companywide solution. This single-system approach may provide a more holistic solution, as vendors often offer supplemental modules (e.g., data conversion tools) that perform functions beyond the typical valuation features. A single-system valuation solution may also enable insurers to establish consistency in governance over data, models, and assumptions. This may be particularly significant for insurers with multiple business units that offer an array of products, especially given that processing runs and assumption unlocking will be more frequent under LDTI. We are also finding that some insurers rely on factor-based legacy administrative system calculations that evolved under the locked-in-assumption paradigm and cannot be easily upgraded for LDTI. A full system replacement may be needed in these instances, ideally leveraging the same preferred vendor system.

While a single-system approach will make this transition easier by establishing a common valuation environment, some companies have expressed concern around the reliance it places on vendors to provide timely model updates. This is compounded by the anticipated timing of these releases, as several vendors are not expecting to release final versions of their LDTI platforms until late 2019 or early 2020. This will leave insurers with a compressed time frame to fully implement and test new models in time to perform sufficient parallel runs prior to going live. In addition to the timing of releases, some insurers have expressed concern about the runtime and grid capacity that will be required to generate LDTI results. These runtime challenges are not unique to the LDTI vendor solutions, as companies that elect to adapt existing models rather than implement vendors' LDTI instances are anticipating the need to conduct iterative runs to satisfy the volume and granularity of the standard's expanded disclosure requirements. Nonetheless, companies may want to evaluate their current capacity and expected requirements as part of their LDTI implementation.

Data

Data has become an increasingly important pillar of insurers' implementation plans, both to execute transition adjustments and to perform the ongoing valuation process post-transition. For their transition, companies are anticipating that **significant efforts may be needed to either resurrect or re-create the required historical data**. We are also finding data availability and consumability to be significant pain points when analyzing the gaps between insurers' current-state valuation processes and their LDTI target state. Many insurers rely on manual data transformations or dated scripts to develop the consumable data that will provide input into the models in their current state. The time and residual risk associated with these types of transformations increase significantly under LDTI given the increased granularity and frequency of updates required. As a result, many insurers feel that significant enhancements are needed to their current state to achieve compliance and are evaluating potential data solutions that enable a smooth LDTI valuation process.

Additionally, the move to a current measurement model for the projection of cash flows may require frequent updates to cohort-level data. Many insurers are debating the **granularity at which they plan to maintain data**, beyond that required to achieve minimum compliance (i.e., at coverage or policy level). Although maintenance at a granular level would improve long-term analytical capabilities, the increased volume may drive up the cost and complexity of data management. A cost-benefit analysis can help organizations reach a final decision on their data strategy.

When thinking through the data needed to support the **experience study and assumption-setting processes** under LDTI, insurers are raising concerns about the resources required to develop and update assumptions annually (or more often). This is particularly notable given that some insurers feel they lack sufficient resources to perform experience studies and assumption updates for products or segments when these are currently performed at a higher level of aggregation. In addition, for some insurers this is a manual process and therefore the resource constraints will be compounded by the increased frequency under LDTI to perform these updates. These deficiencies can be magnified because of the extensive amount of

ad hoc data cleansing that is often required for experience studies. Therefore, many insurers are evaluating potential enhancements in the form of experience study databases or repositories to facilitate a more streamlined future process. In addition, the frequency and/or staggering of updates to the various types of best-estimate assumptions and the products to which they apply are other decisions that insurers may consider to ease the operational burden of these changes.

The volume and granularity of required disclosures increase significantly with LDTI, and companies will be required to disclose detailed information on rollforwards, reconciliations, inputs, judgments, and other statistical measures for their insurance liabilities. These disclosures must be aggregated/disaggregated so that useful information is not obscured by the inclusion of a large amount of insignificant detail or by the aggregation of items that have significantly different characteristics. On the back end, companies are finding that an **actuarial data repository may drive significant time savings** in the reporting process by allowing insurers to query detailed information for their reporting needs. Additionally, a workflow manager may be needed as part of a subledger or data warehouse solution to manage end-to-end processes, from the ingestion of cash flows into the actuarial systems to the posting of journal entries. When analyzing these solutions, many insurers are considering solutions that store output data at the most precise level of granularity, allowing them to build their disclosures with maximum flexibility. These types of strong data solutions will facilitate a smooth production run and minimize the operational risk of generating these complex LDTI disclosures.



Next steps



Expected changes in volatility

Under the new ASU, organizations are anticipating changes in the volatility of their earnings patterns and equity balances. These drivers of change will impact every insurer differently and may include the following:

1. While the use of the yield curve is expected to enhance comparability among insurers, this divorces the discount rate from the associated portfolio. The benefit reserve OCI (equity) amount will therefore move with the yield curve but be disconnected from the company's asset portfolio.
2. Under LDTI, the insurer recognizes any changes in the liability for future policy benefits arising from changes in the discount rate as an adjustment to OCI (equity) at the time the discount rate is updated (i.e., in the current period).
3. As products are unbundled for their valuation under ASU 2018-12, certain assumptions may be tracked at a more precise level of granularity. This may cause additional losses to be recognized due to unfavorable assumption changes on certain cohorts that would have previously been offset by more favorable cohorts upon aggregation.
4. Under LDTI, the net premium ratio cannot exceed 100 percent, with the insurer required to recognize an immediate charge to net income for the period so that net premiums will equal gross premiums.
5. GMxB business is now defined as a MRB and measured at fair value. This represents a departure from current accounting for benefits such as GMDBs, gross GMIBs, and EEDBs that are currently modeled under the less volatile SOP03-1.
6. The change to amortize DAC on a constant-level basis will likely result in a more stable amortization pattern as it will no longer be impacted by discount rate or earnings changes.

The first step in being prepared for the new ASU is to begin mobilization with an impact assessment to benchmark the current state, define the future-state IT architecture, build a roadmap, and develop estimates of the cost and effort to achieve compliance. As part of this mobilization, companies should begin building a business case and establish a governance structure. From there, they can develop a list of entity-specific key strategic decisions, evaluate alternatives, and make informed elections to drive forward the implementation effort.

For insurers that have already begun mobilizing their programs, the next step is to further refine preliminary roadmaps to develop a detailed plan to get through implementation for 2021. Should the work effort include modernization as part of the implementation, a clear distinction should be made between smart compliance objectives and modernization initiatives that may persist beyond 2021. Given the scope of this implementation and its pervasiveness across the organization, bringing the right team to the table will help the company achieve results during this time of change.

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Endnotes

1. FASB, Accounting Standards Update No. 2018-12, Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts, August 2018, https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171066930&acceptedDisclaimer=true.
2. Ibid.
3. Ibid.



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