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FASB long-duration targeted improvements: Transitioning inside and out

In August 2017, the Financial Accounting Standards Board (FASB) approved far-reaching calculation and reporting changes for long-duration products. These changes will impact all business, both prospective (new business) and retrospective (existing business).

To accurately measure the impact of the FASB long-duration targeted improvements (LDTI) on existing in-force business, each company will need to elect one of two transition methods detailed in the guidance—full retrospective transition or modified retrospective transition.

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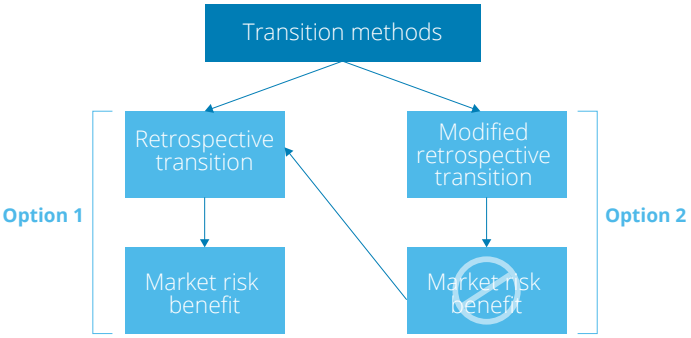
What are the transition options?

The two transition methods offer significantly different approaches to the implementation of the FASB LDTI guidance. In this paper, we'll outline considerations to help insurers determine which method suits their needs.

Figure 1. Two options for transition approach



The retrospective approach

The full retrospective approach allows for an accurate and precise measurement to establish the opening balance sheet at the transition date. It treats each block of business as if it were originally issued under the FASB LDTI guidance and allows for the financial impact to be cumulatively recorded as of the transition date.

In some instances, a full retrospective method may be elected, but due to unavailable data across all products and to all actual historical inception dates, the necessary data are aligned to the earliest date when all product historical information is available. Estimates of the historical data are not allowed. This retrospective date, and all issue dates going forward, are inception dates and are used consistently with the retrospective method. For all remaining contracts prior to the earliest date when all product historical information is available are subjected to the modified retrospective method. This approach essentially creates a transition that is a blend of the modified retrospective transition and the retrospective method but is referred to, throughout this article, as an interim retrospective approach. For business that lacks the appropriate historical data, the transition date remains January 1, 2020.

There is one exception in which a transition choice is not permitted. For market risk benefit (MRB) products (see figure 1), the transition approach is required to use the retrospective transition approach with some allowances ("hindsight") when setting assumptions.

The carryover approach (modified retrospective)

The current industry nomenclature refers to the carryover transition basis as the modified retrospective method. This method provides guidance on how to pivot balances as of the election date (January 2019) and how to record any impacts that occur based on the new guidance. The pivot is accomplished by calibrating key ratios with starting balances to allow actuarial balances to roll forward in a seamless fashion.

Which approach is better?

Faced with determining which transition method is optimal for their business, insurers should invest some time to document considerations leading to their final election.

Electing a transition method should be considered from more than just a financial reporting perspective. There are benefits to both methods, so how does one decide? While there are many criteria one could consider, we'll focus on four:

- **Financial impacts**
- **Data requirements**
- **Control environment**
- **Technology architecture**

Financial impacts

The transition election will directly impact how future earnings will emerge. When thinking about financial impact (see figure 2), insurers should develop an understanding of the potential direction; possible magnitude; and differences of changes due to the FASB LDTI transition requirements.

The first retrospective benefit can be investigated by evaluating recent historical financial results, current accounting policies, and historical cash flows to determine if moving a product valuation retrospectively to the FASB LDTI would best reflect earnings pricing objectives and realizations. A historical loss recognition test set of cash-flow data, if available, may provide a useful starting point to evaluate a full retrospective election.

For example, a significant loss recognition event could be eliminated if the key driver of losses was due to interest rates. Many products were subjected to loss recognition events because the decreasing interest rates significantly raised the gross premium valuation floor Disconnecting interest rate changes from the asset portfolios and eliminating loss recognition testing might reverse some of these impacts. Of course, loss recognition events driven by deteriorating mortality or improving longevity would find little relief in this approach. In fact, the 100 percent cap on the net-level premium percentage and more granular issue-year cohorts might identify new sources of volatility or reserve increases. Without the aggregation across multiple issue years and potentially like products, as allowed prior to the LDTI adoptions, the resurrection of deferred acquisition costs (DAC) balances would be a less likely outcome.

Figure 2. Transition financial considerations

Full retrospective	Modified retrospective
Elimination of loss recognition events (LRE) driven by the low interest-rate environment	Retaining provisions for adverse deviations (PADs) in the discount rate for historical business (and future profit release)
Consistency in the pattern of earnings emergence across all business	Potential for a better net-level premium percentage when carrying value of reserves is higher (due to assumption PADs)
Alignment of historical and future discount rate assumptions	Inclusion of all carrying values will improve the future net-level premium (lower)

Data requirements

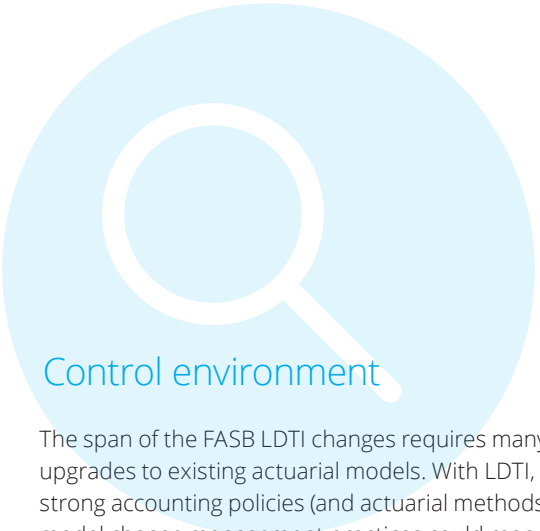
Data is a key consideration under the full retrospective transition election. The data necessary to support the retrospective approach are driven by the number of products and issue years sold. This includes not only the historical valuation in-force files but also data supporting historical experience studies, starting pricing assumptions, new discount rate data, and ledger information. The comparison of benefits and challenges across the data landscape can drive decisions on their own (see figure 3).

Figure 3. Transition data availability considerations

Full retrospective		Modified retrospective	
Benefits	**Challenges**	**Benefits**	**Challenges**
Consistent data requirements across new business and transitional business	Large amounts of historical input data must be managed	Elimination of managing large amounts of historical input and output data	Data requirements are different between new business and transitional business
	Historical data may not be available	Recent historical data required can immediately begin to be collected	

The availability of content and format may also vary. While dualpurpose legacy administrative systems (administration and valuation) might provide census data easily, the older factor-based approach to valuation may not have the basis of mortality rates, lapse rates, or discount rates on a GAAP basis readily available. Valuation processes are subject to system upgrades, system conversions, and data management enhancements that may also make collecting the historical data to support a specific-population retrospective transition challenging.

There is also certain data that has not historically been required for actuarial valuation purposes. As an example, the discount rate data for an upper-medium grade (low credit risk) fixed-income instrument yield must be identified and collected. In addition to collecting the data, the implementation of new assumptions policies may also be required. Even the most current, best-estimate assumption source data may require a reevaluation because disclosure requirements may impact the granularity of assumption analysis. In many instances, the retention of such a volume of data might not be practical or reasonable for legacy blocks of business.

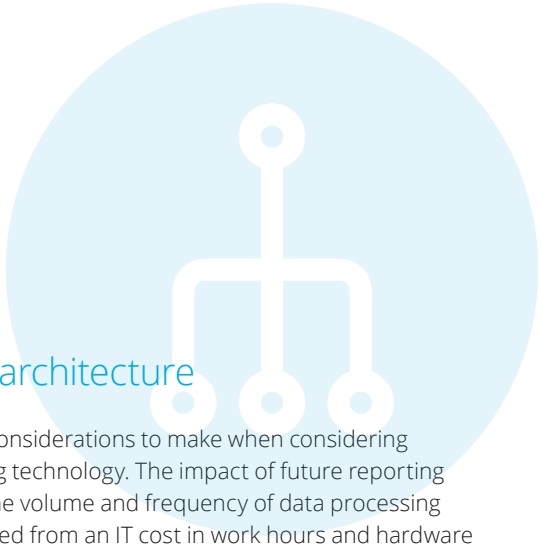


Control environment

The span of the FASB LDTI changes requires many updates or upgrades to existing actuarial models. With LDTI, companies with strong accounting policies (and actuarial methods) and strong model change management practices could reap the benefits of their previous dedication to effective governance. Many wellthought-out plans consider both system upgrades and system conversions, and it is common for new methods and models to have supporting model governance and model validation procedures across the updates. The transition process creates a unique, one-time process that may generate the need for several one-time or unique controls.

The retrospective method also involves revisiting an entity's control environment. Businesses issued and processes established before Sarbanes-Oxley (2002) and the Model Audit Rule (2010) may not have reporting and control standards subject to the same rigor. Moving to pre-2002 dates reopens these time periods to inspection and evaluation—and the controls over the accuracy and completeness of this historical data may be even more difficult to address. Controls over the storage and reuse of legacy model input, legacy model output, or legacy models may not be adequate or may not have been historically tested. These challenges may be exacerbated for each additional year of data incorporated into the retrospective approach.

Further, older controls around the financial results tend to be built around the model output or trending, or are detective in nature. The sheer amount of data needed to re-create all these detective trend controls quickly becomes unreasonable. Further, the trends themselves are less useful when assumptions are not locked in over time. The understanding of developing patterns on a per-unit basis, or trending increases and decreases over time, becomes less useful to detect unusual patterns or to establish thresholds for investigation.



Technology architecture

There are several considerations to make when considering the LDTI supporting technology. The impact of future reporting requirements on the volume and frequency of data processing should be considered from an IT cost in work hours and hardware fees. To better manage scarce internal technology resources, external data storage and processes might play a role in planning. Given the large amount of data needed to complete the close, insightful considerations given to which data are retained—and how and where—will be key.

The new requirements provide an opportunity to design a "single source of truth" for data. This designation will help align controls across multiple procedures, addressing risks within the financial reporting process created over time and improving integration between actuarial and finance. Having data available for analysis is one consideration, but being able to mobilize this information for analysis and insights is entirely another effort. There is much about this new standard that leads data management and storage as well as valuation system modernization. A smart compliance process, including some level of modernization, is often the optimal way to approach new data processes and new valuation controls.

Transition optimization

There are some financial reasons that may make the retrospective transition method attractive over the modified retrospective method. Spending some time evaluating an array of criteria—financial impacts, data requirements, control environment, and technology architecture—will provide the most useful assessment of the transition options. With these criteria in mind, the conclusion on the optimal transition method can consider both financial impacts and resource constraints while also focusing on the redesigned future state (see figure 4 for observations gleaned from the criteria).

Figure 4. Making the transition decision—observations

Consideration	Observation
Full retrospective	The full retrospective method may have the ability to erase historical loss recognition events driven by the low interest-rate environment. The data-intensive nature of this approach, the riskiness of historical control functionality, and the need for a seamless technology architecture or perhaps modernization of data management and supporting technology creates a multiyear project that would be difficult to complete with all this data in the desired time frame. While not specifically identified in the guidance, the interim retrospective method is the application of the modified retrospective pivot method at a date earlier that January 1, 2020 in an attempt to reach a full retrospective transition. Since, however, all of the data does not exist to complete a full retrospective transition, the full data to an interim point is used. Besides the data management, resource strain over model runs, documentation associated with model risk management, change management, model governance, assumption governance, and development of new controls over historical balances will creep across IT, actuarial, and finance. Ultimately, this increases the risk of a successful transition.
Interim retrospective	The interim retrospective method is the second-most data-intensive approach of all the methods. While not specifically identified in the guidance, the interim retrospective method is the application of the modified retrospective pivot method at a date earlier that January 1, 2020 in an attempt to reach a full retrospective transition for available data. Since, however, all of the data does not exist to complete a full retrospective transition, the full data to an interim point is used for select contracts and for contracts where the data is unavailable, the inception date remains January 1, 2020. All the same challenges and requirements that apply to a retrospective transition apply to the interim retrospective method, but some far-reaching data challenges are mitigated for non-MRB business. The limitation of complete and accurate data is used to select an interim inception date, which limits the number of interim reporting periods and reduces the volume of documentation. Care will need to be taken in identifying the new inception date to avoid the appearance of a selective process that identifies the optimal issue year valuation pivot date.
Alignment of historical and future discount rate assumptions	Beginning January 1, 2019, for all but the MRBs, this method locks in certain legacy interest rate assumptions and PADs. By pivoting on the January 1, 2019, balances, a company can immediately identify the new starting data requirements. There are still significant data management requirements for assumption data and reporting requirements. The historical information needs are only for two years, including the profits-followed-by-losses requirements, prior to go-live. Likewise, the additional FASB LDTI model change management and model validation process documentation is needed for a lower volume of model updates. While offering the least flexibility related to the final balances, this approach can be more easily used to target modernization efforts and has the benefit of the most recent year's controls and data environment being the starting point. By targeting the more difficult transition areas for modernization and automation, the shorter historical time frame reduces resource strain by freeing up resources later. This allows a smart compliance process to be built to reduce the modernization work effort during the transition time. Smart compliance targets only the required changes to methods and controls—not the entire valuation and control process. The full modernization effort can be addressed post-FASB LDTI implementation for these smart compliance areas.

There are several criteria beyond operations and infrastructure that a company can use to prioritize and complete this analysis. The examples and explanations above are one set of options. Deloitte has created a series of FASB LDTI publications that detail other ways your company may need to change. Deloitte also has developed tools and accelerators to explicitly help analyze the variation available in the transition phase. In addition to our understanding of ASU 2018-12, we bring smart solutions to help with your modernization and smart compliance needs.

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The publication of ASU 2018-12 defines new regulatory requirements for certain long duration insurance products, otherwise known as the Long Duration Targeted Improvements (LDTI). Despite being finalized, the new requirements are subject to continuous interpretation from the insurance industry and practitioners. Deloitte is closely involved in these discussions and shares its Point of View (POV) to support the application of LDTI. Please note that the Deloitte POV's are written at a point in time and should not be interpreted as stand-alone guidance without taking into account ongoing industry views and evolving positions from both FASB and the Insurance Experts Panel (IEP). Until the industry is nearing the effective date on 1 January 2022, industry views and interpretations such as the Deloitte POV's are subject to change.