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Evaluating experience and setting assumptions: See something, say something

As the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2018-12 ("long-duration targeted improvements (LDTI)" or the "standard") adoption date for large public companies has passed and quarterly production of LDTI financial statements becomes a business-as-usual activity, professionals are beginning to turn their focus to the detailed aspects of the "new normal" within LDTI.

One topic the industry has been debating is the increased focus on experience monitoring and assumption setting in an LDTI context. LDTI requires companies to formally review cash-flow assumptions annually at the same time every year, or more frequently if experience or other evidence indicates a need to revise previous assumptions.

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While examining experience and setting assumptions is not a new phenomenon for actuarial and financial professionals at insurance companies, the LDTI accounting framework increases the impact of assumption changes on current and future earnings and has forced companies to increase the rigor surrounding their formal experience study and assumption governance processes. In addition, while LDTI does not change the quarterly requirements regarding assumption monitoring and changes, it does require companies to coordinate their formal review process and to develop a process to comply with the requirement to monitor experience on "off quarters" outside of the annual assumption unlock.

Leaders in the industry will be able to align off-quarter monitoring activities and communication of trends to internal and external stakeholders such that annual assumption updates do not come as surprises but rather represent the continued maturity and evolution of a rigorous study of experience and evolving actuarial judgment through the year.

Leading practices to monitor experience

As companies begin their quarterly liability for future policy benefits (LFPB) calculations, most will likely replace projected experience with actual experience for the most recent quarter, recalculate net premium ratios, and populate disaggregated rollforwards as required by the standard. Completion of these activities also requires a company to confirm the appropriateness of assumptions used to project future cash flows, even in quarters outside the planned annual assumption unlock. The industry has debated as to the level of analysis and communication required to meet this requirement. Some long-standing positions, though potentially inaccurate, appear to be driving the uncertainty regarding the requirements within the standard:

1. Experience studies and assumption setting are one and the same process.
2. Formal experience studies are the only method to inform assumption changes.
3. Completion of analysis or formal experience studies obligates a company to update assumptions.

Experience studies and assumption setting are not interchangeable

Many professionals use the terms "experience study" and "assumption setting" interchangeably. In fact, these two are separate and distinct activities and should be governed as such. The experience study is the formal analysis of recent trends and may involve comparisons of actual versus expected experience. While this is an input to the assumption-setting process, it cannot be solely used without actuarial judgment to determine if the experience observed is indicative of a long-term trend that should be reflected in future cash-flow projections. In an LDTI context, it is not sufficient to simply state that no assumption updates were made in a given quarter because no formal experience studies were completed. Alternative methods for monitoring experience must be implemented.

Quarterly monitoring—an alternative to formal experience studies

While many companies lack the capabilities and/or resources to perform formal experience studies on a quarterly basis to align with external financial statement production, leading companies will implement a rigorous, repeatable, yet flexible, process to evaluate experience each quarter. These steps might include:

- Evaluation of the trends of net premium ratios, present value of net premiums, and present value of benefits at the cohort level, potentially with a triggering point or threshold to investigate abnormal movements.
- Examination of disaggregated rollforwards to identify outliers in experience that may be indicative of the need for further investigation or developing trends.
- Examination of attribution analyses to better understand the drivers in movements in the market risk benefits and the liability for future policy benefits.
- Early drafts of experience study analysis.
- Source of earnings analyses to assess profit drivers.

While many forms of analysis may be developed and will continue to evolve as companies gain more experience in evaluating the off-quarter experience, the key success factors for this analysis are common:

- Processes must be well-defined and repeatable period over period.
- Analysis must be clear and transparent enough for internal and external stakeholders, including external auditors, to understand.
- Analysis must use data consistent with the data set used in valuation. The data set should be complete, should not be modified, and should not exclude any data points.
- Analysis should make use of information already being produced as part of the quarterly close process and should be automated where possible.
- Analysis needs to remain flexible enough to evolve and mature as the company better understands the available data and the story it is telling.
- Processes should be well governed. It may not be necessary for formal assumption committees to review analyses and conclusions in detail in off quarters, but the committees should be charged with confirming that such an analysis has been completed and reviewed in an appropriate level of detail by valuation actuaries.

What did we observe, and what do we say?

Perhaps even more debated than the off-quarter analysis itself is the subsequent action that should be undertaken either in terms of assumption changes or the communication of the results of the analysis performed to internal and external stakeholders.

Companies are not obligated, nor would it be a best practice, to change assumptions every time this quarterly analysis is performed. Taking such action may result in assumptions that are not indicative of a long-term trend (which usually takes at least six to eight quarters to manifest) and may result in sequential quarters of unlocking. This type of action, whether offsetting or compounding in impact, will likely complicate the communication of results and understanding of management's actions.

While it is true that completion of the analysis does not necessitate an assumption update, it does create an obligation to share observations and emerging trends with the consumers of the financial statements. Companies that don't provide a level of transparency, or simply wait until the formal assumption unlock quarter to discuss observed trends, run the risk of analyst or regulator scrutiny for not effectively acting upon known information. Industry leaders will communicate within disclosures to the quarterly financial statements with regard to emerging experience and the anticipated direction and/or impact of upcoming assumptions changes.

The better approach to communicating assumptions is to have a standing disclosure regarding the state of assumptions. For key assumptions that are within an expected variance, a simple statement to that effect may suffice. Assumptions that are beginning to deviate from expectations should be identified with a note as to the actions that are in place, which may include further investigation or analysis, an in-depth study that may be in progress, and/or a plan to monitor that experience over a period of time. Finally, assumptions for which experience has deviated and a near-term change is required may include language that the final assumptions are being finalized and will be communicated as part of the regular unlocking in a future quarter.

In short, companies should avoid surprises to the consumers of their financial statements. When deviation is seen, companies should share what is being seen as well as the next steps as of that reporting date. When future actions are anticipated, companies should foreshadow the direction and impact when, and only when, management has agreed on the pending update to assumptions. It's as simple as "see something, say something."

Formal experience study and assumption review process

While most companies have a defined process for formally evaluating and setting assumptions on a regular basis, the adoption of LDTI has companies reevaluating and formalizing their experience study and assumption-setting processes, enhancing and automating processes where needed.

What analysis should be performed to set the assumptions each year?

Leading companies will have a centralized list of the universe of assumptions currently in use and a schedule for formally studying them, whether annually or on a rotational basis if certain assumptions are deemed not material to the financial statements. In addition, more and more companies have a risk matrix or ranking that evaluates the risk of misstatement associated with each assumption. Risk factors may include the size of the balance to which the assumption is applied, the sensitivity of the balance to changes in assumption, and/or the degree of judgment involved in setting the assumptions. The risk ranking may inform the rigor and/or frequency with which certain assumptions are formally studied.

Who is executing various steps of the assumption-setting process?

A strong assumption governance process is becoming increasingly prevalent at companies throughout the industry. Central to the governance process is an assumption oversight committee that works across business units. This committee is typically charged with approving the calendar of assumptions to be studied within each business unit, ensuring consistency in practice and in assumption choice where applicable (i.e., mortality improvement, credibility standards, etc.), and ultimately approving the final assumptions that will be used for valuation and maintaining a central database of approved assumptions. This group may also be tasked with ensuring consistency of assumption use across various business functions (e.g., valuation, pricing, asset liability management, financial planning and analysis), where such consistency makes sense.

Below this committee, clear roles should be defined with principles that separate those that produce the study from those that set the final assumptions. Subcommittees at the business unit level may assist in the timely review of experience study work and, ultimately, the recommendation and approval of the final assumptions. Lastly, more and more companies are critically examining tasks performed by their teams and, in particular, their actuaries. Experience studies, which tend to be more mechanical in nature relative to the final selection of the assumptions, are increasingly performed by non-actuaries in a centralized function. This not only achieves the separation of duties described earlier, but also frees up actuaries to carefully analyze the results and apply appropriate judgment in setting the final assumptions.

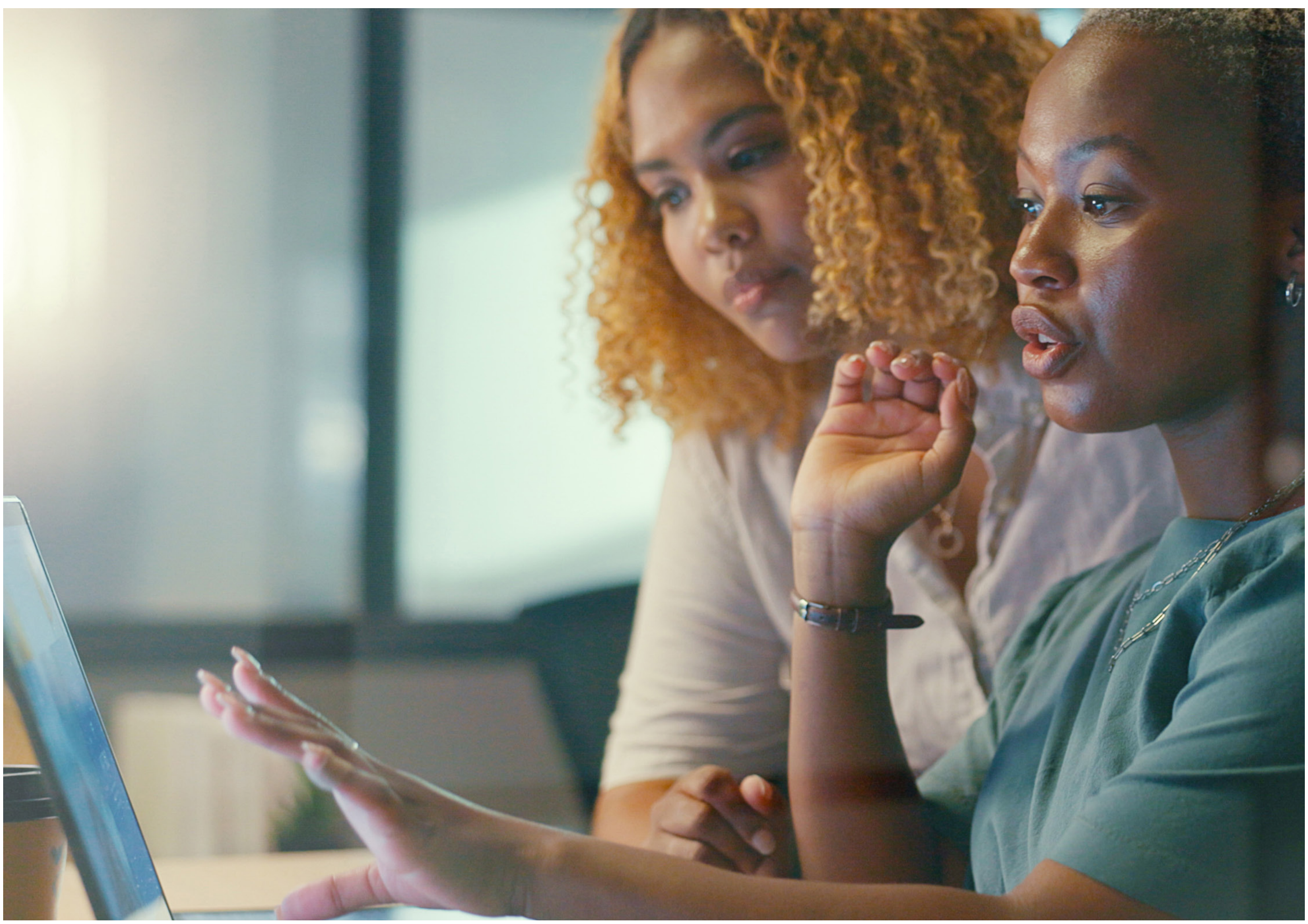
How are companies streamlining experience analyses?

Previously, performing an experience study analysis was akin to assembling a car—it took months and was executed with a high degree of customization. In reality, the experience study and assumption-setting process should be more like driving a car. The car is already built—all the user has to do is turn on the system, check the odometer to see where they have been, and look at other dashboard metrics to figure out where they need to go. With LDTI being business as usual, more and more companies are taking this view and are enabling faster, cleaner, more insightful experience analyses. Mechanical processes involving databases, Excel spreadsheets, and other end-user computing tools are waning in favor of increasing levels of automation and data visualization. Tools such as Tableau, Power BI, and Alteryx have helped companies examine views of experience at different levels of granularity and allow for inclusion and exclusion of populations as needed to quickly identify outlier data points and supplemental analyses to be performed. The ability to examine experience in a dynamic fashion has proven a powerful tool to help identify trends in blocks of business that may warrant assumption changes.

Additionally, companies are starting the experience study process earlier in the calendar year to allow more time for analysis, effective challenge and review, and more time to test, implement, and review model results with new assumptions. This will prove especially important under LDTI where the impact of assumption changes must be quantified at the beginning of the period in which the assumptions are implemented. High-performing companies will be able to quantify the effect of assumption changes well in advance of the quarter close, taking advantage of the requirement for beginning-of-period quantification. This will be critical to meeting close calendar deadlines in the period in which assumptions are unlocked.

Conclusion

LDTI has highlighted the importance of effective analysis and communication of experience trends and the resulting annual assumption changes. While the industry has debated the best way to meet the requirements of the standard, companies best positioned to meet these expectations will use a two-pronged approach of repeatable and focused experience monitoring on off quarters coupled with a well-governed assumption review and approval process in the quarter of the unlock. Both pillars of this approach require effective communication that follows a “see something, say something” approach that clearly articulates the financial statement disclosures trends that are being monitored and how they manifest in quantified assumption changes.



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