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Leveraging LDTI regulatory intersections with IFRS 17, PBR, and CECL

Last year, the US Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI). ASU 2018-12 amends the accounting model under US Generally Accepted Accounting Principles (GAAP) for certain long-duration insurance contracts such as traditional life insurance, disability income, long-term care, and annuities. Specifically, the FASB LDTI guidance seeks to improve the existing measurement, presentation, and disclosure requirements.

FASB's new LDTI standard will have an impact on the financial statements of insurance companies reporting under US GAAP and may require companies to upgrade their regulatory compliance processes—a substantial implementation effort that can squeeze an organization's limited finance, IT, and actuarial resources. The impact can be significant for both US insurers with multinational operations and foreign insurers with operations in jurisdictions where the financial statements are reported on a US GAAP basis.

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For insurers, the implications of more regulatory changes can be compounded when operating in jurisdictions where implementation to newly issued International Financial Reporting Standard ("IFRS") insurance requirements are also in full swing, as well as for US entities adopting the FASB's current expected credit loss ("CECL") model and statutory ("Stat") modifications toward principle-based reserving ("PBR").

Fortunately, ASU-2018-12's implementation time line for public companies coincides with that of the International Accounting Standards Board's ("IASB") new IFRS 17 standard, and LDTI's requirements also dovetail with US-specific regulatory considerations prescribed under PBR. Finally, although CECL affects different balances than LDTI, the impacts of adopting the two standards may intersect in select areas of insurers' operations. These regulatory intersections provide opportunities to leverage synergies and resources for implementation time and cost savings. However, the effective dates for both the LDTI and IFRS 17 regulation are in the process of being amended with a one-year extension for public companies. Until the due process for both regulations is final, they have the potential to disrupt the implementation's aligned time lines for public companies.

Comparing LDTI with IFRS 17, PBR, and CECL

ASU 2018-12 (LDTI)

The goal of ASU 2018-12, which FASB issued August 2018, is to improve, simplify, and enhance the financial reporting of long-duration contracts, providing users with more useful information about the amount, timing, and uncertainty of cash flows. Figure 1 provides an overview of the changes.

Figure 1. Summary of US GAAP changes and impact
"Targeted improvements" create significant impact to data sourcing, processes, and models

Cash flow assumptions

Cash flow assumptions used to measure the liability for future policy benefits **should be updated to current best estimates and recognized in net income.**

Assumptions need to be reviewed and updated if appropriate on an annual basis, at the same time every year, or more frequently if evidence suggests that previous assumptions should be revised.

The ability to produce cash flows leveraging **data that is well controlled is important.**

Discount rate

The company should update the discount rate assumptions that it uses to measure the liability for future policy benefits at each reporting date and recognize any effects of the discount rate change immediately in other comprehensive income. The target **discount rate should be based on an "upper medium grade (low credit risk) fixed income instrument yield."**

For instances where limited observable inputs exist, **processes will need to be developed to establish unobservable points on the yield curve.**

Retrospective unlocking

When nondiscount rate assumptions are updated, a **revised net premium ratio ("NPR") will be calculated using actual historical experience, the updated future period cash flow assumption, and the discount rate applied at inception**. The revised NPR is applied from issue to determine the revised liability as of the B/S date. The difference is reflected in the current period operating income.

The company will need to efficiently and effectively **assess historical experience, requiring quality governance** over experience studies, inputs, models, outputs, and processes given the focus on the use of current assumptions.

DAC

While the definition of expenses eligible for deferral remains unchanged, the FASB has simplified the amortization pattern. **Deferred acquisition costs (DAC) are now amortized in proportion to the remaining life of the contract (e.g., policies in force) over a straight-line amortization period.**

Additionally, DAC no longer accrues interest.

Key decisions will need to be made to determine **where the DAC calculation will take place** and **at which level it will occur (seriatim vs. cohort).**

Market risk benefits

FASB believes that features meeting the definition of **"market risk benefits" ("MRB") should be separately measured at fair value.**

A market risk benefit would be defined as *"A contract or contract feature that both provides protection to the contract holder from capital market risk and exposes the insurance entity to other-than-nominal capital market risk."*

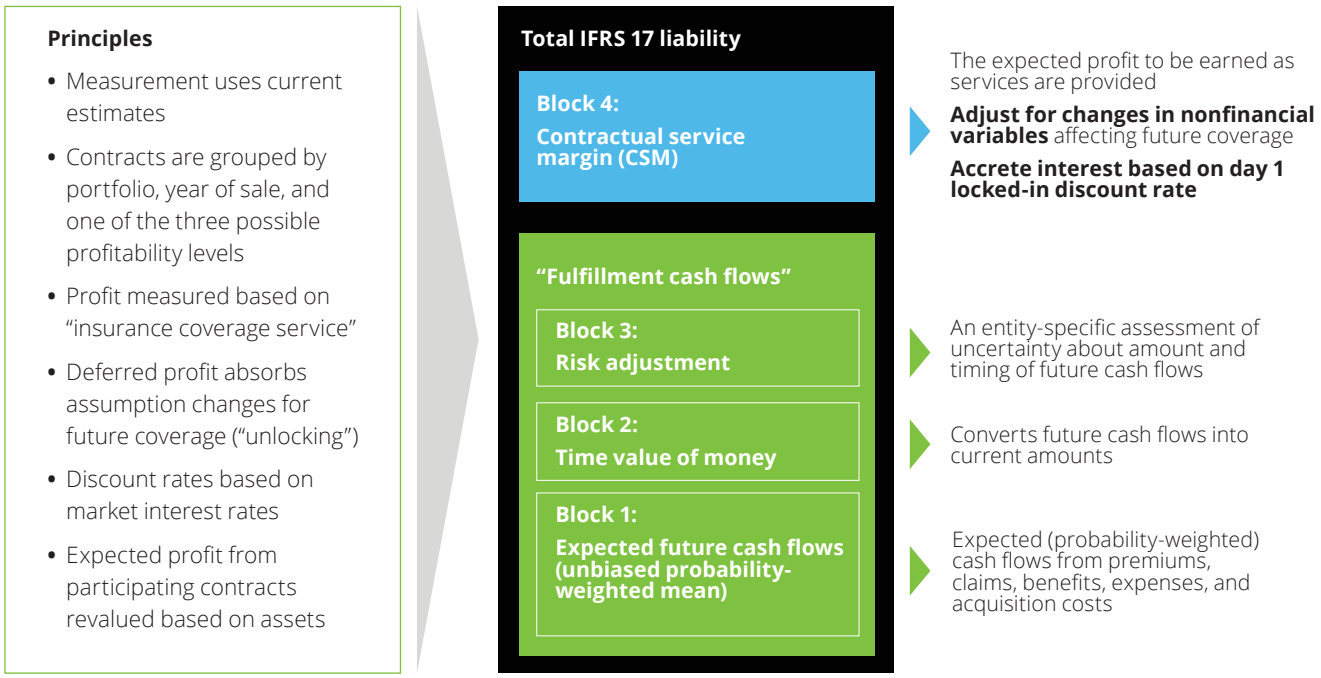
Processes **will need to be developed to identify relevant information** to measure the fair value of market risk benefits.

The end result of these technical impacts is a significant detail on reserve and DAC rollforwards, separate account, and market risk benefit attribution will be required under the LDTI regulation.

IFRS 17

Issued in May 2017, IFRS 17 introduces for the first time a single IFRS accounting model for all types of insurance contracts; its goal is to make the new accounting model highly transparent and align insurance accounting with IFRS accounting of other industries to improve comparability (figure 2).

Figure 2. The IFRS general measurement model
Often referred to as the building blocks approach ("BBA")



On June 26, 2019, IASB published an exposure draft, titled Amendments to IFRS 17, to address concerns and implementation challenges identified following the publication of IFRS 17 Insurance Contracts. The publication of the exposure draft follows an assessment of 25 concerns, identified during the IASB's meeting in October 2018, of areas of the standard that global stakeholders recommended to the IASB for potential improvement. Following its assessment, the IASB has proposed several targeted amendments, including a one-year deferral of the IFRS 17 effective date to January 1, 2022.

1. IASB news release, *IASB consults on amendments to aid implementation of IFRS 17*, June 26, 2019.

PBR

PBR is a new statutory reserve regulation that combines company-specific assumptions with prescribed rule-based requirements. For most states, the new PBR regulation is effective for policies issued in 2020, although entities could begin to convert new issuances in 2017. Retrospective transition is neither required nor allowed.

Under historical statutory reserving requirements issued by the National Association of Insurance Commissioners ("NAIC"), entities were required to use static, and often prescribed, valuation assumptions and techniques. The new approach under PBR is principle based and will require insurers to hold a reserve equal to the greater of the static valuation approach and the more dynamic principles-based approach. The PBR calculation requires the insurer to consider a wider range of potential future outcomes and assumptions in developing the reserve, including assumptions that are specific to the insurer. This regulatory requirement may intersect with ASU 2018-12 in the assumptions used in the PBR reserve calculation. As noted above, this calculation no longer only requires the use of locked-in static assumptions and will likely utilize similar best estimate assumptions used to develop the reserves under ASU 2018-12. Both PBR and ASU 2018-12 require at least an annual reevaluation of reserve assumptions, which is a significant change from the locked-in assumption mechanism of both historical regulations.

One key area where the PBR requirements diverge from LDTI is adoption and transition. PBR does not allow a retrospective adoption of the standard and only allows policies to be reserved for under PBR if issued after January 1, 2017. Because of this option, policies issued between before 2017 and through 2020, will likely be valued using historical approaches and static assumptions, the volatility caused by the policies reserves under PBR will be difficult to identify in the early years but should increase over time.

CECL

In 2016, the FASB released its accounting standards update on financial instruments—credit losses, commonly referred to as CECL. Effective for public companies beginning January 1, 2020, the standard requires entities to recognize expected lifetime losses on a range of financial assets, including most[2] debt instruments (other than those measured at fair value through net income), trade receivables, lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts,[3] and loan commitments. For these asset classes, an entity must measure expected credit losses over the contractual term of the financial asset—prepayments may be considered in this measurement—in consideration of historical loss experience, current conditions, and reasonable and supportable forecasts. Figure 3 provides an overview of the standard's key provisions.

Figure 3. Overview of the CECL model

01 Scope	• Applies to most debt instruments (other than those measured at fair value through net income), trade receivables, lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts, and loan commitments • Does not apply to financial guarantee contracts that are identified as insurance or measured at fair value through net income
02 Recognition	• No minimum threshold for recognition of impairment losses • Valuation account deducted from amortized cost basis to present net amount expected to be collected • In certain situations an entity can recognize zero credit losses; however, no explicit guidance is provided on what these situations would be
03 Measurement	• No prescribed methods to develop an estimate of current expected credit losses, but the estimate should represent lifetime losses • An entity must measure expected credit losses over the contractual term of the financial asset • Consider information about historical loss experience, current conditions, and reasonable and supportable forecasts
04 Unit of account	• Credit losses should be evaluated on a collective basis when similar risk characteristics are shared • When similar risk characteristics are not shared, a financial asset should be evaluated for impairment individually
05 Practical expedients	• Collateral-dependent financial assets (Allowance = Difference between amortized cost and collateral's fair value) • Financial assets secured by collateral maintenance provisions (Allowance = Limited to the difference between amortized cost and collateral's fair value)

Given LDTI's and CECL's respective scopes, each will have an impact on different balances within an insurer's financial statements. However, CECL's requirement to estimate financial instruments' lifetime losses at each valuation date is, in some ways, conceptually similar to the reserve framework prescribed under LDTI for insurance contracts. Although the calculations will likely occur under separate processes, CECL and LDTI may share similar solutions to effectively operationalize each. As a result, strategic implementation of the two standards may present certain operational and functional opportunities for insurers seeking to leverage interaction between the two.

2. The CECL model does not apply to the following debt instruments: Loans made to participants by defined contribution employee benefit plans; policy loan receivables of an insurance entity; pledge receivables of a nonprofit entity; and loans and receivables between entities under common control.

3. The CECL model does not apply to financial guarantee contracts that are identified as insurance or measured at fair value through net income.

Leveraging operational synergies

The new IASB, FASB, and NAIC pronouncements can have a pervasive impact on global insurers' operating models, predominantly for those with operations in the United States. Companies required to comply with IFRS 17 and CECL, as well as companies that are moving toward principle-based reserving for statutory-basis financial statements, should consider leveraging potential synergies with LDTI in their implementation planning.

For several areas—especially as it relates to process design, modeling system/technologies, data availability and storage capabilities, and reporting solutions—the work companies do to prepare for IFRS 17 compliance as well as CECL and PBR may be able to be leveraged for LDTI to enhance efficiencies, increase cost savings, and reduce resource requirements.

Process and system design

Given the accounting changes prescribed by these standards, insurers may seek to leverage similar processes across accounting bases. For example, the approach to deriving discount rates for LDTI, IFRS 17, PBR, and CECL discounted cash flows may leverage a centralized method. In such scenarios, although the standards may apply different rates and apply the rates in different projection tools, converging the process to deriving these rates will facilitate a more integrated environment and eliminate the need for parallel business processes and controls. Additional process changes that may be made consistently across standards may include:

- System logic and account-mapping changes may be updated in conjunction across standards to support technical reporting requirements. Several finance software vendors have specialized calculation solutions for IFRS 17 and for LDTI to some extent.
- If a single vendor solution is used in the valuation of reserves for LDTI, IFRS 17, and PBR, the related process flow—from data origination in administrative systems through posting into the general ledger—can leverage similar interfaces and handoffs to ensure consistent transformation routines.
- Consolidation of data repository and reporting solutions can enable consistent back-end storage, reporting, and analysis.

In these instances, the processes, controls, and target operating models that reflect changes to the reserving, finance, and reporting processes can be designed to govern across standards and bases of accounting.

Actuarial systems and modeling

Specific modeling and valuation applications may be needed to support updated estimations, risk adjustments, and discount rates associated with these standards. While likely to require separate modeling modules to execute the disparate reserving methodologies, LDTI, IFRS 17, and PBR may all require insurance-specific vendor decisions and software integration for compliance. As a result, modeling alternatives should be contemplated in tandem so that multiple reserving platforms or procurement of multiple actuarial software providers aren't required to support the standards.

Across these standards, insurers may consider points of convergence that minimize the need for completely disparate implementations and optimize their modeling and calculation processes.

Data quality and integration

Data will play a central role in the implementation of all four of these standards. These regulatory changes all require calculations to consider more data by requiring insurers to unlock reserves under the LDTI and IFRS 17 models, remeasure loss estimates under CECL, and apply a more dynamic PBR valuation approach than the current historical static Stat methodology. In addition to the frequency at which these standards require updates/unlocks to their calculations, insurers will face greater data needs to execute these calculations:

- LDTI reserve calculations may require significantly larger data volume and granularity of data as the standard states that cohorts cannot "group contracts . . . from different issue years but [must] group contracts into quarterly or annual groups." This may significantly increase the number of cohorts—and corresponding cohort-level data—from current US GAAP by being required to store historical cash flows from inception of the contract. Disclosures will also significantly increase the volume of data through the need to produce granular disaggregated rollforwards across insurance balances.

- IFRS 17 will require significantly more data due to the need to measure and report insurance liabilities under the building blocks approach, increased use of market data, requirement to segment portfolios based on annual profitability groups, and a new method of presenting insurance revenue. IFRS 17 disclosures will also require more extensive disclosures than are currently required today.
- PBR requires insurers to consider a wider range of potential future outcomes and assumptions in developing the reserve under its principles-based approach, increasing the input data needed to develop a range of forecasts.
- CECL requires the measurement model to consider significant additional input data than required in previous loss estimation models—including historical default and delinquency data, risk grades, prepayment and collateral information, and loss-given-default and exposure-at-default estimates.

Additionally, because LDTI, CECL, and IFRS 17 standards are adopted retrospectively and require an intensive review of historical loss data, current conditions, and forecast/projection results, additional IT resources may be needed to support the standards. As a result, these standards will have a significant impact on the need to extract, manage, and store data. By considering the needs collectively, insurers may consider common technology solutions such as data warehouses or unstructured databases with the capabilities to address enterprises' additional data needs.

Financial reporting and disclosures

Notably, LDTI, IFRS 17, and CECL all require insurers to expand on existing disclosure requirements. Under LDTI, prospective required disclosures include disaggregated tabular rollforwards, reconciliations to core financial statements, and other statistical information across insurance balances at each reporting period.

To comply with these requirements, companies' reporting frameworks may need to be redefined or new tools may need to be implemented to facilitate an efficient reporting process. Defining a new architecture for the data repository, subledger, and general ledger should be at the center of an insurer's reporting strategy as the foundation of strong solutions that will facilitate a smooth production run and minimize the operational risk of generating these additional disclosures. The main challenge will be to build a strong data foundation that can support the different accounting bases that enable the actuarial and finance functions to further integrate and speak a common language.

Assessing functional impacts

Each of the standards may individually drive changes in the way insurers manage their business, as many anticipate significant shifts in the timing and volatility in which earnings prospectively emerge. However, certain functions sit at the intersection of these impacts. To effectively manage these changes, functions may need to reevaluate the tools and analytics currently applied in today's decision-making processes. While these changes will be felt across the organization, the following represent those functions that may be most affected by the intersection of the changes:

- **Investment management:** Insurers with a more US GAAP-centric investment strategy may consider adjustments to their asset portfolios and derivative/hedging strategies given the de-linking of the asset portfolio from the liability discount rate under LDTI, resulting changes to prospective earnings patterns arising from the two standards, and changes to the loss measurement model under CECL. However, even those with an IFRS- or Stat-focused strategy may seek to refine their investment strategy in consideration of volatility shifts across accounting bases. However, it is important to note that potential changes to benefit one or more of the accounting bases may not result in consistent investment objectives do to differences in reserving.
- **Risk management:** Many insurers heavily leverage reinsurance as a means of managing risk and/or earnings patterns. Under these standards, insurers may therefore seek to evaluate their US GAAP-, IFRS-, and Stat-basis impacts to determine whether additional reinsurance is desired to more effectively manage their risk. Within the context of their US GAAP reinsurance, insurers will further need to consider CECL's impacts in recognizing an allowance for losses on reinsurance recoverables.
- **Product design and pricing:** On a US GAAP basis, the combination of CECL's requirement to recognize credit losses on the portfolio of assets backing an insurance block, the de-linking of the insurance discount rate from the asset portfolio when measuring earnings, and the prospective LDTI measurement models may cause insurers to reevaluate their pricing on current and future products. On an IFRS basis, insurers will similarly face a new measurement model and may consider shifts in their portfolio pricing and risk appetite due to the standard's requirement to segment based on profitability for valuation. Furthermore, PBR's dynamic principles-based approach may cause insurers to evaluate changes to their portfolio and consider potential changes to statutory capital requirements.
- **Treasury/capital management:** Because many insurers manage their capital primarily based on statutory results, changes arising from PBR implementation may cause significant shifts in capital management strategies. However, even under US GAAP and IFRS accounting, insurers may experience significant shifts in volatility of both earnings and equity that could have an impact on leverage targets, capital flexibility, required capital, hedging, and cost of capital. Insurers will likely find that macroeconomic changes will affect earnings faster under CECL than current US GAAP, as loss estimates will be assessed at inception rather than upon occurrence of a loss event. Under LDTI, macroeconomic assumptions that historically were locked in on certain business will be periodically unlocked under LDTI. IFRS 17 also introduces a greater use of market data to update assumptions used in determining the contractual service margin of the related contracts, which therefore could have an impact on company-specific capital management.

Given the scope of these changes, a broad plan that effectively leverages the interdependencies between these standards can help insurers plan for the changes both at adoption and prospectively post-transition. To facilitate this effort, insurers should review their respective impact assessments to identify areas of overlap and leverage those in pursuit of an integrated, end-to-end design to implement multipurpose processes and controls that converge across standards.

Accounting interaction between LDTI and IFRS 17

In addition to assessing the operational overlap between the standards, Deloitte compared a number of IFRS 17 and ASU 2018-12 technical areas to identify the primary differences between the two given that they generally address similar balances and types of products:

- Contract definition/scope
- Cash flows (boundary)
- Time value of money (discount rates)
- Risk margins
- Onerous contracts
- Premium allocation approach
- Level of aggregation
- Reinsurance
- Presentation
- Disclosures

Our analysis shows that while US GAAP is moving closer to a current value framework, for long-duration contracts, there are still fundamental differences in the framework between IFRS 17 and ASU 2018-12 (figure 4).

Figure 4. For long-duration insurance contracts, there are fundamental differences between IFRS 17 and LDTI

01 **Reserving approach**	• The IFRS 17 fulfillment cash flows essentially follow a gross premium valuation approach, which captures all future P&Ls at valuation. A contractual service margin ("CSM") is then set up to defer the profit, which is a unique concept under IFRS 17 • US GAAP is a ***net premium valuation*** approach, which effectively recognizes the profit loadings in premiums as they are received. Deferred profit liability is only set up for limited-pay contracts or contracts with excessive charges
02 **Computation requirement**	• IFRS 17 requires a current value, as the unbiased "probability-weighted mean of the full range of possible outcomes" Measuring the time value of options and guarantees ("TVOG") is necessary to determine its cost • Under current US GAAP, the deterministic approach is prevalent for benefit reserves and SOP 03-1 for certain guarantees due to their "book value" nature. Under LDTI, while deterministic is still prevalent, MRBs are measured at fair value, which would involve stochastic runs
03 **Unit of account**	• IFRS 17 requires the evaluation of ***at least three groups of contracts for any given issue year*** for a portfolio in the CSM rollforward to determine P&L. Grouping of onerous contracts is based on individual contract level calculation unless there is reasonable and supportable information • LDTI ***allows up to an issue year*** or more granular cohort by product. No impairment testing on DAC
04 **Financial impact of assumption unlocking**	• ***Prospective unlocking*** under IFRS 17, where changes in future assumptions do not result in any current period I/S impact, to the extent the impact can be absorbed by the CSM • ***Retrospective unlocking*** for US GAAP benefit reserves for long-duration contracts, where future assumption changes have an impact on the current period income
05 **Revenue recognition**	• IFRS 17 revenue is based on ***derived figures*** involving actuarial calculation • Under US GAAP, ***premium*** is recognized as revenue for traditional long-duration products and ***margins*** are recognized as revenue for nontraditional products (such as universal life)

Moving forward

Smart compliance seeks the optimal trade-off between achieving minimum compliance and a desired level of sustainable future efficiencies. Considering the time line for implementation, the breadth of the prescribed changes, and companies' time and resource constraints, we are seeing many insurers planning for short-term solutions that will enable required LDTI reporting. However, some organizations are looking to broaden and modernize their minimum compliance efforts to develop an effective future-state operating model. While achieving full modernization prior to the new standards' effective dates is likely to be unfeasible for many insurers, those working to kick-start smart compliance should evaluate their current framework for capability gaps and then balance the cost and time line implications to realize maximum value across accounting bases from their implementation efforts. If there are any regulatory overlaps that apply to your organization, the time would be well spent to apply the lessons learned from current in-flight accounting changes and focus on the data overlap and systems implications to maximize operational efficiencies.

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