Think beyond compliance: Source of earnings in the LDTI world

In August 2018, the US Financial Accounting Standards Board (FASB) issued its Accounting Standards Update (ASU) 2018-12, also known as Targeted Improvements for Long-Duration Contracts (LDTI or "the Standard"). LDTI amends the existing accounting requirements under US generally accepted accounting principles (US GAAP) for certain long-duration insurance contracts, such as life insurance, disability income, long-term care, and annuities. It represents the most significant change in the past four decades to the US insurance accounting framework and consequentially translates to impacts on companies' financial systems, data, and processes. Among other pervasive changes, the new retrospective calculation of liability for future policy benefits (LFPB) and the disaggregated rollforward disclosure requirement pose significant challenges for companies' ability to track and store both historical and projected cash flows at a very granular level.

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The introduction of the market risk benefit concept and its valuation also demand enhanced computing power and stochastic system solutions for the fair value calculation and related financial disclosures. To achieve effective compliance when implementing LDTI, companies affected by the new standard have been making considerable investments in talent, technology, and data capabilities.

As companies commit resources to their implementations, they also face the challenge of explaining the financial results to internal and external stakeholders in a changing environment. Moreover, with so much investment being made to produce, store, and track granular cash flows and multiple attribution runs, many insurers are seeking other value-added insights that can be extracted from the LDTI solutions to form management insights and inform business decisions.

One way for companies to clearly articulate the earnings results that arise under an LDTI framework is through a source of earnings (SOE) analysis. LDTI creates an opportunity to enhance SOE analysis for those that already have a robust process today or introduce one for those that don't. Changes under LDTI move US GAAP reporting closer to a current value framework, which renders the US GAAP metrics more useful to reveal the performance of the underlying economics of the business, beyond just explaining the financial results.

As companies consider deploying the source of earnings, the following key steps ensure a successful deployment.

- **Identify strategic decisions** – Analyze which questions must be answered to proceed
- **Define the baseline** – Agree to high-level definitions to best capture enterprise earnings under the emerging framework
- **Customize definitions** – Tailor SOE margins to meet stakeholders' needs
- **Develop requirements** – Strategize future-state data sourcing for tailored definitions
- **Implementation** – Perform testing and deploy

Identify strategic decisions

One of the key benefits to SOE analysis is the flexibility of a company to define a framework that can meet its business needs. It can be adapted for external reporting, management reporting, product development, in-force management, product profitability, and capital deployment, among many other uses. Before building a SOE framework, leading companies will answer the following strategic questions:

- What questions are we trying to answer that we cannot answer today, and how does the SOE analysis help?
- To what extent do the definitions for SOE analysis need to be consistent across products and/or business segments?
- Is the SOE analysis purely an explanation of the actual earnings? Is it analysis of actual versus expected earnings? Are GAAP earnings or operational earnings the focus?
- Can the framework be easily extended to multiple accounting bases, product drill-down analyses, and actual versus pricing? Which of these are the priority?

Answering these questions will help a company prioritize its build efforts and define the work steps needed to execute the build of this reporting framework.

Define the baseline

In today's environment, there are a wide range of practices within the industry regarding the granularity, definition of components, and ownership of the SOE analysis. Business units within the same organization may produce different views of the SOE due to differing product design and features, which makes a companywide view of the SOE difficult to produce without the initial step of defining the data sources for consistency.

However, LDTI presents an opportunity for companies to harmonize disparate definitions and ensure an effective means of explaining results is established. With the adoption of LDTI, there will be increased transparency into insurance company operations. This will increase demand for actuaries and finance professionals to not only produce the detail that feeds into the financial statements, but also explain the drivers.

For illustrative purposes, we are defining a simplified example baseline framework. The framework example below is for a company looking to explain actual GAAP earnings for a traditional life block of business under LDTI.

Illustrative SOE construct for life products

Underwriting margin	Mortality margin	Morbidity margin	Surrender margin	Premium margin	Other in-force margin
Investment net spread	Spread income				
Expense and other margins	Amortization expense margin	Other expenses			
Assumption unlocks	Mortality unlock	Morbidity unlock	Lapse unlock	Other unlock	
FX movement	FX adjustments				
Other	Corrections	Adjustments	Refinements		

It should be noted that the framework focuses on explaining the earnings reflected in the LDTI income statement. Excluded from the analysis is an explanation of the emerging equity volatility that will arise under LDTI. The volatility will arise when there are changes in interest rates and the impact of the movement in the LFPB due to a change in the "upper-medium credit quality" market rate used for discounting is captured in accumulated other comprehensive income (AOCI). This impact may or may not be offset by asset impacts flowing through AOCI in the form of unrealized gains and losses on available for sale (AFS) fixed maturities. To the extent these impacts do not align, companies will need a way to explain the apparent disconnect that may emerge in the AOCI portion of the balance sheet.

An insightful analysis to bridge the gap between the AOCI disconnect in the external-facing balance sheet and the underlying economics of the business will need to be considered elsewhere in management's reporting. This analysis may consider exploring methods to isolate the AOCI disconnect emerging from noneconomic factors (unrealized gains or losses on AFS assets supporting equity where there is no offset due to LFPB remeasurement). Additional efforts can be taken to confirm that the remaining disconnect is consistent with known asset and liability characteristics of the underlying business, such as potential duration mismatches.

Completion of this analysis alongside the source of earnings will allow the company to better understand both the income statement and balance sheet that emerges under LDTI.

Customize definitions

Current-state US GAAP SOE constructs are effective—for traditional life products in particular—due to the locked-in nature of traditional life reserves and deferred acquisition cost amortization (DAC). Fundamental changes to the LFPB and DAC calculations under LDTI require careful reconsideration from a SOE perspective, in particular:

- The inclusion of actual experience in the net premium ratio (NPR) used to calculate the benefit reserve
- The periodic unlock of assumptions
- The exclusion of interest from the DAC calculation and the simplified amortization approach

We consider each of these changes in determining an appropriate LDTI source of earnings framework.

- ***The inclusion of actual experience –*** There are two impacts that must be considered when experience deviates from expected under LDTI. First, consistent with legacy GAAP, profits emerge if experience is favorable relative to the beginning of period estimate. Second, one must consider the impact of actual mortality, morbidity, surrenders, and other experience on LFPB.

  Note that the impact on DAC due to the true-up is not included in the mortality or surrender margin. Given that LDTI DAC is on a constant-level basis, which functions more like an asset depreciation than an insurance balance, the actual-to-expected variance due to experience within the DAC balance can be included in the expense margin.

- ***The periodic unlocking of assumptions –*** Per the requirements of the Standard, 944-605-35-1B, "Cash flow assumptions shall be reviewed—and if there is a change, updated—on an annual basis, at the same time every year." Any change in the assumption will directly affect LFPB, DAC, and other balances to be accounted for in the SOE. Companies may choose to include the impact of assumption unlocks either within existing drivers (the impact on actuarial balances due to a mortality assumption update would be recorded in the mortality margin) or on a separate line item in the SOE. Operationally, a separate line item may provide more transparency into the impact of assumption updates (including separation of actual historical experience).

- ***The exclusion of interest from the DAC calculation –*** Eliminates any interest margin that can be generated on the unamortized DAC balance in a legacy SOE analysis. The interest margin is redefined as the interest earned on the beginning-of-period invested asset-backing liabilities plus beginning-of-period cash flows less the interest built into the locked-in LFPB accretion.

  Similarly, because the amortization basis for DAC is no longer connected to revenues (premiums for traditional life business), it is more appropriate that the premium margin is adjusted to exclude the DAC expense from net premium. Thus, the premium margin can be redefined as gross premium less the net premiums for benefits and qualified expenses included in the LDTI LFPB calculation.

The framework allows management a clear tool to describe the impact of experience true-ups, assumption unlocks, and NPR movements to investors, auditors, rating agencies, and other key stakeholders. As we explore the necessary data in subsequent sections, we will identify that most of the data elements required to populate this analysis are readily available within the LDTI-required disclosures and can be included in the SOE without significant excess effort. Additionally, once the framework is built, there is potential to examine earnings at whatever level of granularity that is supported by the underlying data. Distribution channels, products, and even cohorts could be examined through the same lens. Lastly, this framework could be extended and enhanced for other (nontraditional) products. While some of the definitions may need to be expanded or refined, the key drivers are included such that an enterprise-level SOE is achievable.

Develop requirements

A challenge, historically faced in developing a meaningful and insightful SOE, is that key data elements may not be consistently available in an accessible format across the finance and actuarial functions. Companies often lack a single source of the truth, which leads to reconciliation challenges. Company data may also lack the desired granularity, resulting in allocations, approximations, and simplifications that limit the accuracy and usability of the SOE.

The increased LDTI transparency generated by enhanced disclosures clearly requires a significant increase in data sourcing, storage, and tracking (from valuation to ledger to disclosures). With the focus on enhancing data sourcing, storage, and tracking capabilities to support LDTI reporting and disclosure requirements, an opportunity exists to enhance LDTI data management efforts to insert additional data requirements needed for a future-state SOE. While many of the data elements required for the LDTI reporting and disclosures can be leveraged, the breadth of an SOE modernization effort may require different granularity, data, and collaboration beyond that involved in the LDTI financial reporting.

Disaggregated rollforward runs

Many of the data elements that are required for the LDTI disaggregated rollforward disclosures can be used to create a foundation for the SOE. Consider the following examples:

- The Standard requires a rollforward of both the present value of expected future benefits (PVEFB) and the present value of expected net premiums (PVENP). One of the components of the rollforward steps is the “Effect of actual variances from expected experience.” Most companies will have details available to break down these variances between mortality experience, morbidity experience, and lapse. The effect of actual variances from mortality experience in the PVEFB line less the effect of actual variances from the PVENP line is the second term in the mortality margin discussed above.
- The rollforward of PVEFB and PVENP also requires disclosure of “Effect of changes in cash flow assumptions.” The difference between these lines is exactly the detail required for the new assumption unlock line within the SOE.

The above examples illustrate foundational information that, by investing a bit more time to establish the next level of granularity required by the Standard, can produce layers of insightful and valuable SOE reports. While companies may tend toward minimum compliance to ease the operational strain, industry leaders will see the added value of an explicatory tool with or without further attribution runs from the actuarial valuation systems.

Data sourcing

Other data elements will be needed for the SOE analysis beyond those which will be utilized and produced for financial reporting under LDTI. Key data items such as actual gross premiums, actual benefits paid, expense, and investment income are sourced from the general ledger or other data systems that are not owned by the actuaries. The granularity and availability of this data will affect the granularity at which the SOE can be developed and/or where ledger and subledger changes are needed to produce more granular results for accuracy and insight. Furthermore, should the company seek to pursue more granular detail than is available from nonactuarial data (for example, investment portfolio performance that does not exist at the cohort level), the development of allocation methodologies and definitions may be necessary.

The ability to source the data effectively and timely will greatly affect the quality and relevance of the results of the SOE. A central data warehouse that hosts financial data coming from the actuarial valuation, finance, claims, and investment systems may become key as one “single source of truth” in order to facilitate the creation of a real-time SOE analysis.

Level of aggregation

Companies can tag the financial data produced for LDTI disclosures with key identifiers, such as product type, distribution channel, and even cohort such that the SOE and other management reports can be developed at lower levels than required by the Standard in order to provide insights that not only explain the results, but also drive strategic insights.

Take cohort definition as an example. LDTI eliminated the premium deficiency test for traditional life products. The LFPB, however, requires the net premium ratio to be capped at 100%, which essentially forces the recognition of losses to the cohort level. As companies finalize their interpretation and contract groupings under LDTI, it's possible they will arrive at a cohort definition that allows some level of loss offset within the permissible spectrum of practices. However, some companies may desire for a SOE analysis to drill down to a more granular level in order to investigate the profitability of certain products or businesses. In that case, the company's LDTI implementation journey should configure its systems to include additional data requirements or processing in order to allow for more granular management analysis.

Operating model

A proper operating model is required to ensure there is clarity as to who owns the overall SOE and who owns the various SOE inputs. Multiple teams would need to collaborate, including actuarial, finance, claims, and investment, in order to bring the information together to form a holistic SOE story. A natural division is for the actuarial function to own the drivers and explanation of the mortality, surrenders, persistency, and assumption unlock while the finance and/or investment function owns the explanation of interest and expenses.

With clearly and appropriately assigned ownership and accountability, a well-designed operating model could help facilitate the transition to LDTI not only for financial reporting, but also for management analysis and decisions that are driven by US GAAP metrics and profitability analysis with deep explicatory support.

Implementation

While LDTI implementation is a compliance exercise, it introduces an opportunity for companies to supercharge their financial analysis and layer insight into business performance. The ability to think beyond compliance and harness the power of financial data to align financial analysis, decision-making, and market-facing explanation will become a distinguishing factor for insurance company leaders in a post-LDTI world.

Seeing the value in the SOE analysis, leaders in the industry can integrate management reporting into their overall LDTI project plans:

- **Dedicate a team of finance and actuarial stakeholders to lead the development of this effort.** Underinvestment in this aspect will lead to this effort being deprioritized and left for a "Day 2" item when it is most needed in the early stage of LDTI adoption to maximize the leverage. The outcome of this effort is a clear owner and governance group.
- **Agree on the framework between finance and actuarial stakeholders.** These differing stakeholder groups may bring different insights and company knowledge and can work together to align early on a holistic SOE. The outcome of this effort is a clear set of requirements.
- **Identify data elements and sources to support the framework and where gaps exist.** Data remains the biggest challenge for most companies in their LDTI journey, and the SOE is no different. A current-state analysis is key to understanding the potential data limitations that could affect the design of the future-state SOE. Start with the end in mind, stepping backward into the financial reporting and valuation processes to identify data gaps and required information sources with clear definitions to drive the data collection. The outcome of this step is a set of crisp definitions.
- **Iterate the framework based on cost, benefit, and prioritization of building and extracting data elements.** As new reports such as the SOE are identified and business requirements are written, additional fields or reference tables may be required to source and tag the data to support the desired framework. Decisions regarding the future state must weigh the value delivered against the effort to build out the ledger, subledger, or data warehouse to support the SOE.
- **Test the new reports.** Ensuring sufficient testing cycles will allow users to become familiar with the new reports, identify any defects, and ensure the reports are ready for production when the Standard goes into effect.

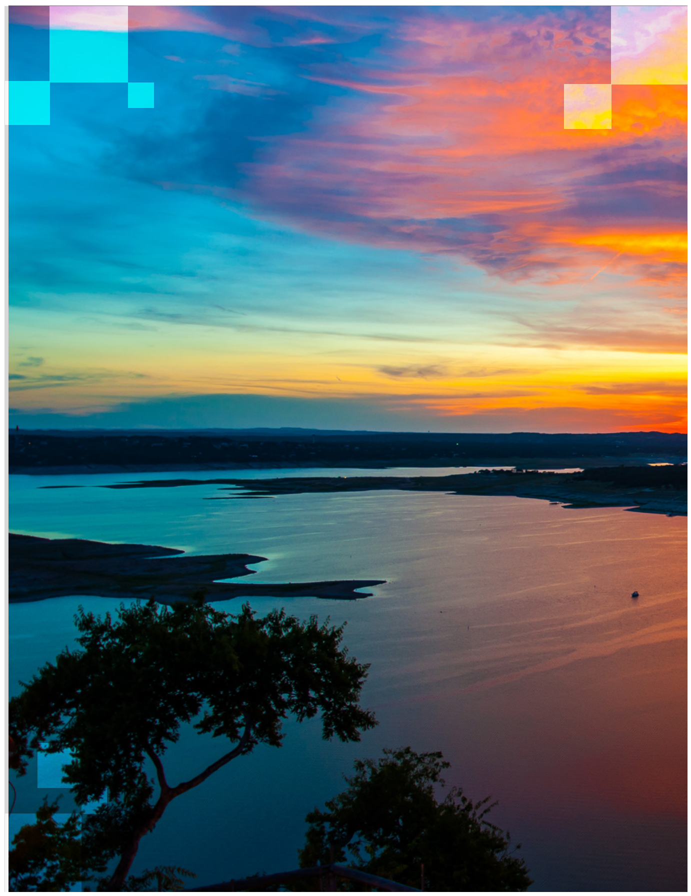
Concluding thoughts: A call to action

The cost of regulatory compliance associated with LDTI has been and will continue to be significant. As previously noted, the depth of this SOE analysis within a company can vary, but so can the breadth, based on other financial reporting bases (e.g., IFRS, US Statutory for PBR, and other areas). At the end of the LDTI implementation project, stakeholders will ask what additional capabilities were enabled beyond the minimally compliant standards. The source of earnings is a natural extension to current programs and is a way to utilize existing spend to bring value and insight to the organization. It can distill all changes into a simplistic method of describing business performance in a complex world.

Success can be achieved by keeping in mind the following guiding principles:

- ***Transparency –*** Make sure all parties are effectively communicating and everyone is aligned
- ***Understanding –*** It is imperative that dedicated project resources are willing to learn and completely understand all aspects of the reporting basis
- ***Consistency –*** All areas of the business will need to agree on the framework and definitions. All parties should strive for consistency and recognize the importance of alignment.

While the LDTI source of earnings may not be a priority item on current LDTI project plans, now is the time to begin an assessment of the current SOE requirements, process, and data availability to unlock the full potential of this new LDTI transparency.



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