INSIGHTS FROM THE BDO INSURANCE PRACTICE

What to Know About Changes in the LDTI Implementation Journey

GUIDANCE OVERVIEW

Organizations need to comply with changes to the standard for Targeted Improvements to the Accounting for Long-Duration Contracts Issued by Insurance Companies (LDTI), and the implementation journey for compliance can be complicated. The effective date varies depending on entity type, but taking a proactive approach can help business leaders understand the specific requirements and estimate the financial impact for their organization, which will enable them to better address potential risks and duration gaps.

In August 2018, the Financial Accounting Standards Board (FASB) issued ASU 2018-12 (Topic 944), which provides authoritative guidance revising the accounting for long-duration insurance contracts. **The guidance has four main objectives:**

Improves the timeliness of recognizing changes in the liability for future benefits and standardizes the rate used to discount future cash flows.

Simplifies and improves the accounting for certain market-based options or guarantees associated with deposit (or account balance) contracts.

Simplifies the amortization of deferred acquisition costs.

Requires additional enhanced disclosures, including disaggregated roll-forwards for the liability for future policy benefits, policyholder account liabilities, market risk benefits and deferred acquisition costs.

IDENTIFYING COMPLEXITIES IN THE LDTI IMPLEMENTATION JOURNEY

When preparing for the effective date of the new standard, some companies have faced hurdles in their adoption process. First, COVID-19 resulted in a remote work environment and presented unique challenges for the LDTI implementation journey. Collaboration across actuarial, IT, accounting and finance is critical to the successful implementation of LDTI, and working remotely made such collaboration more challenging. In addition, large data sets and actuarial models require significant computing power and capacity. The remote environment resulted in companies experiencing slower processing times while accessing systems and applications. The remote work environment hampered companies' ability to physically go to the whiteboard, brainstorm as a group and draw ideas to aid in facilitating solutions.

As many companies are still evaluating their current physical footprint, the work-from-home trend has changed how employees communicate, collaborate and perform activities within processes supporting LDTI. The pandemic also shifted many resources that would otherwise have been focused on LDTI adoption to perform various ad-hoc analyses to address the impacts from COVID-19 and to analyze other potential impacts to the financial statements.

Additionally, industry developments in a number of key areas such as market risk benefits, discount rates, unit of account and reinsurance have delayed implementation progress. These changes have impacted conducting end-to-end testing, performing restatements and parallel runs, tackling internal and external reporting, and addressing changes in processes, controls and automation. For example, an insurer's definition of cohort is essential for determining how a business block is categorized for purposes of net premium ratio (NPR) testing, discount rates used, how assumptions updates are developed, how financial disclosures (i.e., roll-forwards of beginning-of-year reserves to end of year) are allocated, how valuation reserves are calculated and how reinsurance treaties are appropriated. These units of account that are measured via cohort definition are utilized to determine whether a specific cohort block may require additional funding due to inadequate reserves (NPR ratio > 100%).

Even without the challenges related to those industry developments and COVID-19, adoption of the new standard can be complex and require significant IT efforts. For example, system integration and user acceptance testing activities are critical to ensure a cohesive end-to-end process and successful adoption. It is also necessary to validate whether the hand-offs at each point in the process are working correctly by testing data inputs, model calculations, model outputs and reporting aspects.

For internal reporting, emphasis on defining various management reports, dashboards and metrics is needed. LDTI also introduces significant additional financial reporting disclosures which may require the creation of standardized reports and roll-forwards that will aid in fostering an efficient closing and financial reporting process. Once the data, valuation modeling and reporting aspects have been established, processes and controls can be assessed, refined or newly created. Also, restatement of prior-period financial information exposes companies to a high level of risk given the potential time constraints and the level of historical data and analysis needed.

It is important to perform restatement calculations on the future-state systems platform, so planning should anticipate several rounds of iterations as the platform continues to be refined. In addition, modeling systems should be on a "first principle" basis rather than "total lives" basis in order to better match LDTI issue-year discount rates to cohort-specific level claims and policies in the financial projection runs. For parallel runs, smaller companies will be better positioned to perform these tests due to benefitting from a later implementation date, learning from larger peers' implementation processes and challenges, and any beneficial observations and further guidance post-LDTI implementation for larger public filers.

While most companies have substantially recovered or adjusted to the COVID-19-related challenges, LDTI industry developments and a changing economic backdrop, organizations continue to be forced to balance the constraints of their reduced budget with mitigating the pandemic-related costs.

NEED TO KNOW: TIMELINE OF FASB CHANGES AND EFFECTIVE DATES

- June 2020: The FASB proposed a one-year deferral of the effective dates for ASU 2018-12. The amended date for SEC filers (excluding smaller reporting companies) is January 1, 2023, for annual and interim financial statements. All other entities will be required to apply the standard in calendar year annual financial statements in 2025 and interim financial statements in 2026. Early adoption is permitted with certain amendments.
- December 2022: The FASB issued LDTI relief for Transition for Sold Contracts, ASU 2022-05. This recent amendment to ASU 2018-12 allows an insurance entity to make an accounting policy election to exclude certain contracts from LDTI requirements when they have been derecognized because of a sale or disposal of contracts or legal entities before the LDTI effective date.
  - Due to the fact that LDTI guidance is required to be applied retrospectively to the earliest period presented, the FASB issued this amendment for "sold contracts" since these disposed blocks of business have no effect on an insurance entity's future cash flows. Such a reclassification could be perceived as misleading to financial statement users. In addition, ASU 2022-05 may allow some LDTI implementation flexibilities and opportunities for non-SEC filers with later transition dates.

RISING INTEREST RATES CUSHION ADOPTION

While rising interest rates can be challenging for many sectors, the higher interest rate backdrop, along with the financial rebound from pandemic lows, has significantly lessened the impact from adopting the new LDTI guidance. Over the past calendar year, the Federal Reserve boosted overnight lending rates significantly with four consecutive 75 bps hikes and one 50 bps hike between June and December of 2022. More recently, the Fed has begun to pivot on rates, with smaller 25 bps increment increases in February and March 2023. The Fed is expected to taper off its rate hikes by the middle of 2023. Overall, the Fed's aggressive rate increases have elevated short-term interest rates (i.e., 2-Year Treasuries) from below 1% at the beginning of 2022 to 3.76% as of March 24, 2023, as well as dramatically shifting the whole yield curve upward toward the Fed's communicated 5% targeted rate.

These higher rates could help cushion the financial impact of LDTI implementation. Insurance products such as long-term care, disability income, guaranteed minimum death benefits and variable annuities should benefit from valuation and modeling in a higher interest rate paradigm, which will result in a lower recognized liability upon LDTI implementation.

Higher rates also mitigate reinvestment rate risk, which is a key driver of the profitability of many rate-sensitive products. Another potential risk is duration mismatch between assets and liabilities, which could also be allayed as rates continue to climb. This assets and liabilities management (ALM) risk was highlighted by S&P Global Ratings during a recent Society of Actuaries Annual Meeting: "Companies have not been looking to close the duration gap, but rather chase yield. But under LDTI, companies will get no credit for this, so they'll have to change strategies and try and close duration gaps."

ANALYZING THE INITIAL ESTIMATED FINANCIAL IMPACT

As illustrated in the table below, most companies are expecting a material adverse LDTI financial impact reflected in accumulated other comprehensive income (AOCI) primarily from the lower LDTI discount rates that were expected at the time the calculations were performed. As previously noted, rising interest rates will mitigate some of this impact. Note that Cigna sells mostly short-duration insurance products, so it is not as vulnerable to long-duration rate changes.

The LDTI impacts listed below vary widely between 0% and 19%, mainly correlated to age, volume and type of long-duration reserves held.

For example, insurers that hold more specialty products (i.e., long-term care and disability income) and variable annuity reserves are forecasting larger LDTI financial impacts. Given the variability in historical discount rates used under previous guidance, it is not unusual to see similar impact trends across entities.

Also, because the new guidance requires yearly best estimate assumptions updates and recognition of changes in market risk benefit assets and liabilities, future financial earnings may experience more volatility. Note that LDTI changes the timing of net income recognition, not the underlying economics; these earnings variations can be minimized by appropriate hedging/option programs.

Company	Long-Duration Reserves	Expected LDTI Earnings Impact	% Impact	Data Source
Prudential Financial	146,000,000,000	-2,500,000,000	-2%	3Q22 10Q & 2021 10K
MetLife	421,000,000,000	-18,000,000,000	-4%	3Q22 10Q & 2021 10K
Brighthouse Financial	120,000,000,000	-7,000,000,000	-6%	3Q22 10Q & 2021 10K
Cigna Corporation	5,300,000,000	n/a	0%	2021 10K
Unum Group	36,000,000,000	-7,000,000,000	-19%	3Q22 10Q & 2021 10K
Genworth	70,000,000,000	-13,000,000,000	-19%	3Q22 10Q & 2021 10K
CNA Financial	37,400,000,000	-2,300,000,000	-6%	3Q22 10Q & 2021 10K
Berkshire Hathaway	62,400,000,000	-5,000,000,000	-8%	3Q22 10Q & 2021 10K
AFLAC	105,000,000,000	-19,000,000,000	-18%	2021 10K
CNO Financial	27,000,000,000	-2,000,000,000	-7%	3Q22 10Q & 2021 10K

The source of all the data above comes from 2021 10K & 3Q22 10Q SEC filings.

Each business should take steps to estimate the financial impact LDTI may have in terms of potential risks and duration gaps relative to the applicable effective date. Working with third-party insurance industry professionals can help organizations navigate the LDTI implementation journey.

Contact BDO's Insurance practice to discuss guidance for helping optimize LDTI implementation.

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