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LONG DURATION TARGETED IMPROVEMENTS (LDTI)

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LONG DURATION TARGETED IMPROVEMENTS (LDTI)

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Laura Gray is the national leader of KPMG's actuarial practice and a principal of the firm. With more than 25 years of insurance industry consulting experience, she advises life insurance companies on financial reporting, regulatory compliance and modelling issues, including assessing the impact of LDTI. She also co-sponsors the KPMG insurance accounting change solution team, where she leads the development and delivery of client services to assess and implement accounting change.

R&C: With US GAAP is undergoing some significant changes for insurance, could you provide an overview of Long Duration Targeted Improvements (LDTI), as issued by the Financial Accounting Standards Board (FASB) in its Accounting Standards Update (ASU) 2018-12?

Chang: On 15 August 2018, the Financial Accounting Standards Board (FASB) issued 'ASU2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts' (LDTI), which applies to insurance entities that issue long-duration life insurance contracts in the US market. The LDTI standard introduces four targeted improvements. First, assumptions used to measure the liability for future policy benefits (FPB) for traditional and limited-payment contracts. Second, measurement of market risk benefits (MRB). Third, amortisation of deferred acquisition costs (DAC). Fourth, disclosure, which introduces new requirements such as liability rollforwards and information about significant inputs, judgments, assumptions and methods used in the measurement.

Lammons: This is a significant change for many insurers that impacts how they measure, recognise, present and disclose insurance contracts that are considered 'long duration'. It has been a long time in the making, with discussions going back to a joint project with the International Accounting Standards Board (IASB). FASB's intention with its accounting stands updates (ASU) – issued in August 2018 – was to improve, simplify and enhance the financial reporting of long-duration contracts, including providing users with more relevant and current information. In November 2019, the FASB deferred effective dates, so for year-end companies, the effective date for Securities and Exchange Commission (SEC) filers other than smaller reporting companies – as defined by the SEC – is now 1 January 2022. For all other entities, the effective date is 1 January 2024. However, insurers may elect to adopt the new standard early if they so choose.

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>
> *Laura Gray, KPMG*

R&C: How is LDTI different to current generally accepted accounting principles (GAAP)? What entities will be impacted by the change?

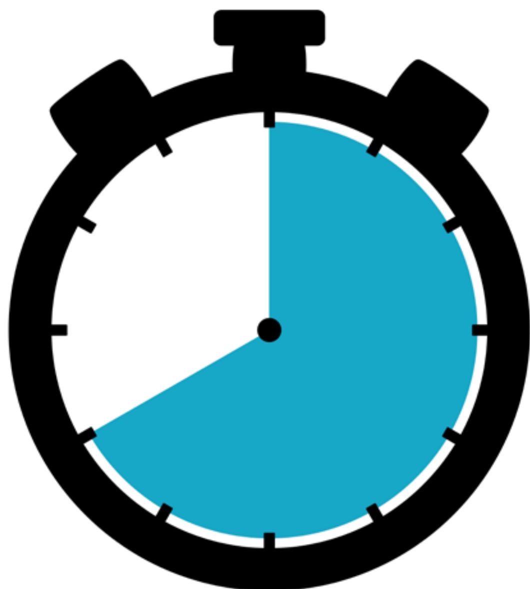
Gray: At a high level, LDTI will require changes in four key areas. First, insurers will need to start reviewing, and if evidence suggests, updating assumptions used to determine the traditional insurance liability values at least annually – consistent with non-traditional products – including the use of updated discount rates each reporting period. Second, there will be a consistent account model to valuing certain product features with market-related features, called MRBs. Third, amortisation of DAC will be greatly simplified. Fourth, insurers will need to provide users with significantly expanded disclosures. LDTI applies to insurance companies that issue long-duration contracts, including universal life type, limited payment, whole life and term life, and apply GAAP for financial reporting.

Chang: To elaborate, annuity, universal disability contracts and long-term care – referred to ASU944-20-15 – are also subject to LDTI.

R&C: For companies looking to prepare their processes for LDTI compliance, where should they start? What end state should they seek to achieve?

Chang: LDTI implementation involves multidiscipline across organisations, such as IT, actuarial and financial. The initial step of identifying the gap between what the company has and what the company needs to comply with the regulation is crucial. The principles of LDTI introduce substantial changes compared to the current US GAAP. These changes increase the complexity of data requirements, data storage and calculations, as well as the scope and processes required to produce disclosure requirements. All these changes need insurers to transform or modernise their capabilities so that an end-to-end process can be in place to effectively and efficiently meet LDTI requirements. Bridging the gap among various systems, including actuarial, accounting, general ledger and reporting, is also an essential component of transformation. The end state is that the process enables actuarial and financial professions to not only comply with the regulation, but also to have better access to and understand of their financials.

Gray: The significance of effort needed to implement LDTI cannot be overstated. Although the new standard is 'targeted', the changes are not simple. LDTI introduces new data requirements, and may require significant changes to systems, processes and internal controls. It is no wonder that many companies are seeking guidance on where to begin. The first step to implementing a new standard is to assess the change. What we have learned from



other change programmes is to keep the end state in mind when thinking about reporting requirements and to consider data requirements – and whether data is properly captured and subject to internal controls. Consider how granular your new required LDTI disclosures need to be. Also consider how these new disclosures help you to 'tell your story', including how these disclosures articulate back to your management discussion and analysis (MD&A), press releases, analyst and investor presentations, and management reporting. Once you have assessed gaps between current US GAAP and reporting under LDTI, consider how you will design your response to the accounting change and how you will implement the design. The last phase is to sustain the new processes and controls and securely embed them in business as usual. The desired end state to be achieved should be an automated and tested process, with strong controls and documentation to govern business as usual, with models and systems being validated for reliability.

R&C: What lessons can be drawn from the process of implementing and complying with IFRS 17? How can companies apply these lessons to improve their LDTI preparations?

Lammons: Although LDTI and the International Financial Reporting Standard (IFRS)17 apply different technical concepts, there are some fundamental concepts that apply to both, and we have found a number of lessons in common that should prove useful for the implementation of LDTI. The most important element of a successful project is good leadership, which requires a vision of what the end process should look like. Strong leaders stay involved throughout the life cycle of the accounting change programme, ensuring milestones are met, issues are resolved, and outputs are validated. In our experience, the single biggest success factor for a large-scale change programme is the presence of full-time staff dedicated to the project – staff with a wide range of skills in project management, accounting, actuarial, data management and IT implementation, and who know your business. It is

important to consider human resource needs now, as we have experienced scarcity of qualified insurance resources, and resources can begin to experience project fatigue at various points in the process as well. Additionally, it is important not to view this as an actuarial, finance or compliance project in isolation from other parts of the business. LDTI is as much an IT and data management project as an actuarial and finance project. Implementing LDTI requires a multidisciplinary effort. Another important lesson we have learned from IFRS 17 is to allow enough time to prepare the groundwork and formulate the plan at the beginning of the process – getting it right the first time. There is nothing more discouraging than to get to the end of the implementation and realise that the end process was not what was intended or that you could have rethought processes along the way to achieve more efficient or enhanced processes. Lastly, acknowledging upfront that changes in circumstances are inevitable and maintaining flexibility are critical to a successful LDTI implementation programme.

Chang: The major areas that companies need to address for IFRS 17, which are also applicable to LDTI, are accurate financial statement results and disclosures within the reporting timeline, increased granularity for management information, a transparent and auditable approach for end-to-end process, and reduced ongoing operational costs in an agile and robust process. An LDTI process covering many new functional requirements is unlikely to be supported by any of the systems that US insurance companies currently use. Thinking holistically is key. Even though some elements of the LDTI process may be, or should be, supported by existing actuarial tools and general ledger systems, we see significant value in providing an integrated approach from choosing a unified platform that supports all LDTI requirements. A single platform for risk and finance analytics and reporting ensures consistency in common data, enables comparability of data and eases the reconciliation of results. At the same time, it fosters closer collaboration among IT, actuaries and accounting staff.

> **"LDTI is as much an IT and data management project as an actuarial and finance project. Implementing LDTI requires a multidisciplinary effort."**
>
> *Michael Lammons, KPMG*

R&C: What specific considerations do dual basis reporters or multi-GAAP companies need to make?

Lammons: The necessity to file financial statements on a multi-GAAP basis – most commonly IFRS and US GAAP – can require a completely different set of books or accounting basis adjustments to be made each reporting period. While many operational and financial processes would be similar, LDTI and IFRS 17 are fundamentally different accounting standards, which lead to different processes and controls. An approach to minimise the complexity of this burden is to leverage common technology platforms for reserving calculations, adjustments and financial reporting entries for both IFRS 17 and US GAAP. As the underlying policy data and source information is largely the same, a single solution can integrate data components and actuarial output and provide parallel workflows to manage both reporting bases concurrently. This helps alleviate the need to have a financial reporting team duplicate the same processes and controls and reduces the potential for reporting errors.

Chang: Insurers benefit from an arsenal of proven technology and capabilities used in similarly complex areas in banking, such as IFRS 9, and insurance, such as IFRS 17, while filling LDTI gaps in their IT, actuarial and finance landscape. The following can be done in a centralised environment and a unified technology platform during the financial close. First, leveraging one common insurance data model for different accounting bases, including LDTI and IFRS 17. Second, configurable process workflows that allow insurers to configure multiple processes, or workflows, aligned with different bases that can be run in parallel. Third, a configurable subledger that insurers can use to configure multiple charts of accounts and multiple sets of posting rules – one for LDTI and one for IFRS 17. Finally, access to managerial reports and disclosures aligned to a different accounting basis.

> **"Companies moving faster will have access to better resources, while slow deciders will face difficulties in ensuring the necessary resources."**
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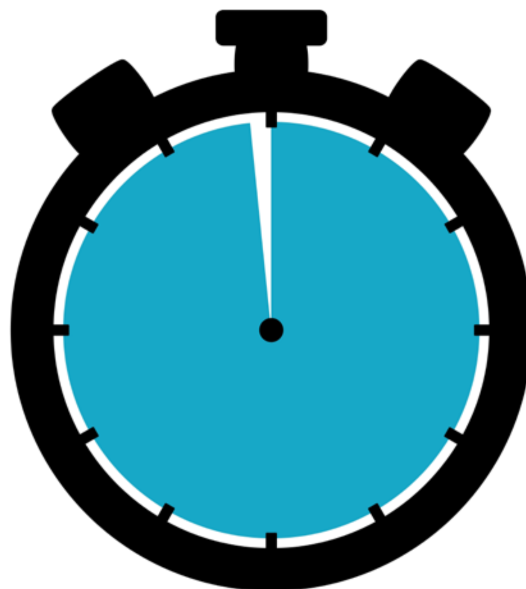
> *Naxine Chang, SAS*

R&C: In your experience, what are some of the common challenges that arise when integrating new systems and processes for LDTI compliance?

Gray: It is common that insurers rely on multiple actuarial solutions for different blocks of business. This produces multiple different outputs which may lead to aggregation issues – issues that will become more complex as a result of the new LDTI data requirements. A solution would be to implement an automated data feed that aggregates outputs in a uniform manner from multiple actuarial solutions. In addition, insurers appear to be more focused on the actuarial phase of the implementation at this point in time, and may not have devoted much thought to what needs to happen following the development of cash flows. Because LDTI is a multidisciplinary effort, it is important to remember that the analysis and design of the solutions need to be seen through all lenses with the end state in mind. Given time challenges to meet effective dates, a potential solution is to automate LDTI calculations – using actuarial cash flows – that produce journal entries and quantitative information for required disclosures. As we consider challenges, some insurers are viewing LDTI as a catalyst for system and process improvements, or even for comprehensive finance and actuarial transformations. This will drive greater efficiency, transparency and value within an organisation. For others, LDTI landed at a time when the insurer was already engaged in another transformation effort.

Chang: Besides common challenges such as data granularity, modelling, disclosure requirements, sub-ledger posting, technology automation and timeline, companies also need to find the staff to implement the new standard successfully. Implementation teams require the full-time attention of a multidisciplinary internal team, the assistance of external subject matter experts and personnel from a technology provider. Companies moving faster will have access to better resources, while slow deciders will face difficulties in ensuring the necessary resources.



R&C: To what extent does the COVID-19 pandemic create additional challenges and complexities?

Lammons: The current environment is causing insurers unprecedented challenges and disruptions, which introduces impacts on business, both directly and indirectly. As a result, insurers are rapidly executing on evolving strategies in an effort to reduce adverse economic impacts, while remaining attuned to heightened government, public and social pressures, as well as maintaining regulatory compliance, in addition to maintaining progress on their LDTI implementation programmes. Setting aside the current environment, insurers were already experiencing implementation challenges, such as data control, actuarial process and modelling changes, including processes that rely on third parties for information, and explaining impacts to senior management and third-party financial statement users. New disruptions are causing a strain on internal and external resources that are working on LDTI implementation programmes, while adapting to new ways of working. Insurers have begun to evaluate the impact of these disruptions on employee communication systems, project plans and timelines, and are seeing delays related to actuarial and finance system builds and testing. Early indications certainly point to risks of meeting the tight implementation deadline. While we understand there is industry discussion around seeking relief on the effective date as a result of the current environment, our advice to insurers is 'not to take the foot off the pedal', as it is not uncommon for insurers to experience time challenges during implementation, but rather consider a range of contingencies in their planning process.

Chang: To add more colour, we learned from IFRS 17 that 'buy vs. build' is one of the most significant decisions that companies need to make. Building a system internally provides a sense of control, but unprecedented challenges when issues such as COVID-19 arise. This can make it extremely hard for companies to continue focusing on application development while pursuing business continuity efforts. Besides, building it on your own requires your company to stay current on all existing requirements and to thoroughly anticipate future changes. You also run the risk of not being able to successfully complete each element required for an end-to-end process. Most insurers tend to favour either the 'buy' strategy or a hybrid strategy, enabling them to mix internally developed components with external solutions.

R&C: What steps do companies need to take now to ensure they are ready to meet the demands of LDTI standards?

Gray: To the extent insurers have not assessed their technology needs, now is the time to advance

discussions with stakeholders and consider what investment is needed. Many actuarial solution vendors have issued communications on their plans and release dates, and it is clear that development timelines vary significantly by provider. Most vendors are planning a phased approach for adopting changes needed to comply with LDTI, adding functionality with each release. There is not a 'one size fits all' solution when it comes to accounting change. Insurers that partner with solution vendors on the development of solutions and engage vendors to develop company-specific requirements, tend to achieve a more desirable end state. Collaboration and transparency between IT and data and accounting and actuarial will be key in maximising design, build and test windows, which will greatly reduce rework at later stages of implementation or the need for ad-hoc solutions. Although getting to the destination – the end of implementation – is important, what is more critical is that insurers take time during the journey to analyse technical aspects of complying with the new requirements, in particular as principles and their interpretation are applied for the first time, and ensuring the methodologies chosen can be applied again. With that in mind, having a unified, controlled, scalable technology platform that bridges both actuarial and accounting – a platform that has the ability to aggregate outputs from multiple actuarial systems, automatically calculates financial statement line items that generates journal entries and quantitative disclosure information, handles multi-GAAP reporting, and instantly drills down to cohorts for management reporting analyses – will offer multiple benefits, such as a streamlined close process and a fully integrated financial processing architecture.

Chang: It is clear from IFRS 17 customer engagements that the largest insurers are planning for 18-month implementations, while medium and smaller insurers are planning eight-month implementations. Expect similar implementation timelines for LDTI given the broad range of impacts on current legacy systems, such as requirements for granular data to be captured at an enterprise level, new calculation requirements in FPB, DAC and MRB, additional processes to integrate actuarial and finance workflow, new accounting processes including reconciliation, attestation, disclosure and managerial reporting, and governance requirements for transparency and oversight. Stakeholders are interested in the impact on the financial position of their company. They would like to see some estimates as soon as possible, and the IT environment to support the new standard requires substantial changes. Just as important, once all these changes are made, systems will need to be tested and run in parallel for at least several quarters. Waiting is not an option. R&C