# Impact of long-duration targeted improvements (LDTI) on insurance models

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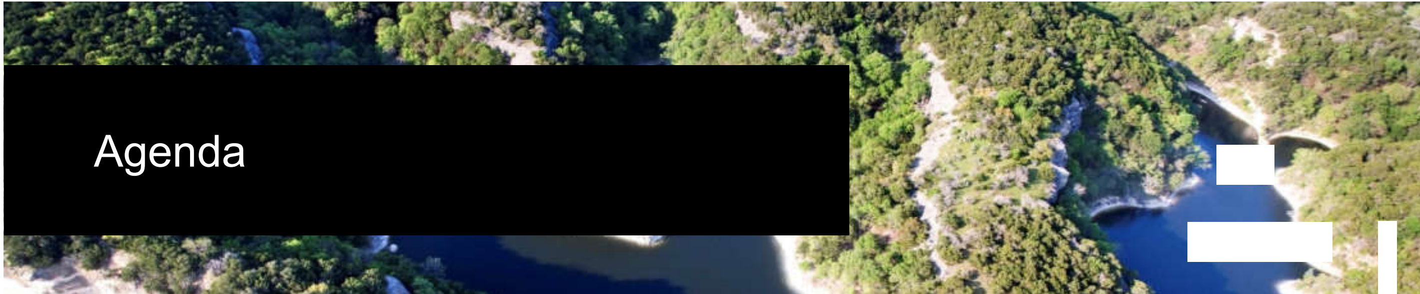


- **Summary of Changes and Emerging Observations**
  - Benefit Liabilities – Traditional Long-Duration Contracts
  - Deferred Acquisition Costs
  - Market Risk Benefits
  - Enhanced Disclosures


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# Benefit liabilities – traditional long-duration contracts

Formerly locked-in assumptions will be updated (at least) annually

Updated cash flow assumptions applied retrospectively, discount rate assumptions applied immediately

- Updated cash flow assumptions to be reflected in net income
- Updated discount rate to be reflected in Accumulated Other Comprehensive Income

Cash flow assumptions to be best estimate (with no provisions for adverse deviation)

Discount rate to be based on an observable “upper medium grade” fixed income instrument yield


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# Benefit liabilities – traditional long-duration contracts

Transition may be easier for companies with a "PGAAP mindset"

- Transitioning at current carrying values is very similar to a purchase GAAP exercise using a "defined initial reserve" approach – a new benefit ratio is calculated using the current reserve balance and updated assumption, with contract "issue" being updated to the transition date
- Maintenance expenses are no longer reserved – they are recognized as incurred.
- Reserve releases are not allowed, unless offset with a deferred profit liability


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## Benefit liabilities – traditional long-duration contracts

How does retrospective application work?

- Actual experience now matters, with benefit ratios being calculated back to contract issue at each reporting period

- Assigning traditional contracts to a cohort and tracking the experience of that cohort will be a new operational exercise for companies

- Additional governance will be required around new processes


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## Benefit liabilities – traditional long-duration contracts

What about changes in the discount rate?

- (At least) two reserve calculations will be required at each reporting period: one at the original discount rate applicable to the cohort, and one at the current upper-medium discount rate

- The difference between the two calculations will be the associated Accumulated Other Comprehensive Income balance sheet quantity

- Guidance has yet to emerge around how to reflect the duration characteristics of the liability, in other words, a preference for a single rate vs a term structure


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## Benefit liabilities – emerging observations

Expectations of more favorable reserve changes in income than current GAAP

- Move to best estimate assumptions removes provisions for adverse deviations from assumptions which, all else equal, slows reserve growth, producing more favorable earnings as reserves accumulate

- Accumulated Other Comprehensive Income impacts were very unfavorable to GAAP Equity at the 12/31/2020 transition date, but have largely reversed during the rising rate environment of 2022

- Limited Pay business largely offsets favorable benefit liability movements with correspondingly unfavorable Deferred Profit Liability movement (net premiums not used for funding benefits become excess gross premiums to defer)


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# Deferred acquisition costs

Amortization of deferred acquisition costs (“DAC”) on all long-duration contracts (except investment contracts using the interest method) will be over the expected life of the book of business and in proportion to insurance in force (or another measure if insurance in force can’t be reasonably estimated)

Interest would not accrue on DAC balances

DAC is exempted from loss recognition testing


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## Deferred acquisition costs

What does this mean, practically?

- Earnings emergence WILL change
- Actual impacts will potentially vary greatly depending on the underlying sources of profits for products, current practices around DAC amortization horizon, etc.
- If feasible, it might be worth investigating both transition options (current carrying value and full retrospective) for possible future earnings emergence impacts
- Guidance still isn't firm for other quantities such as VOBA that are currently amortized similarly to DAC


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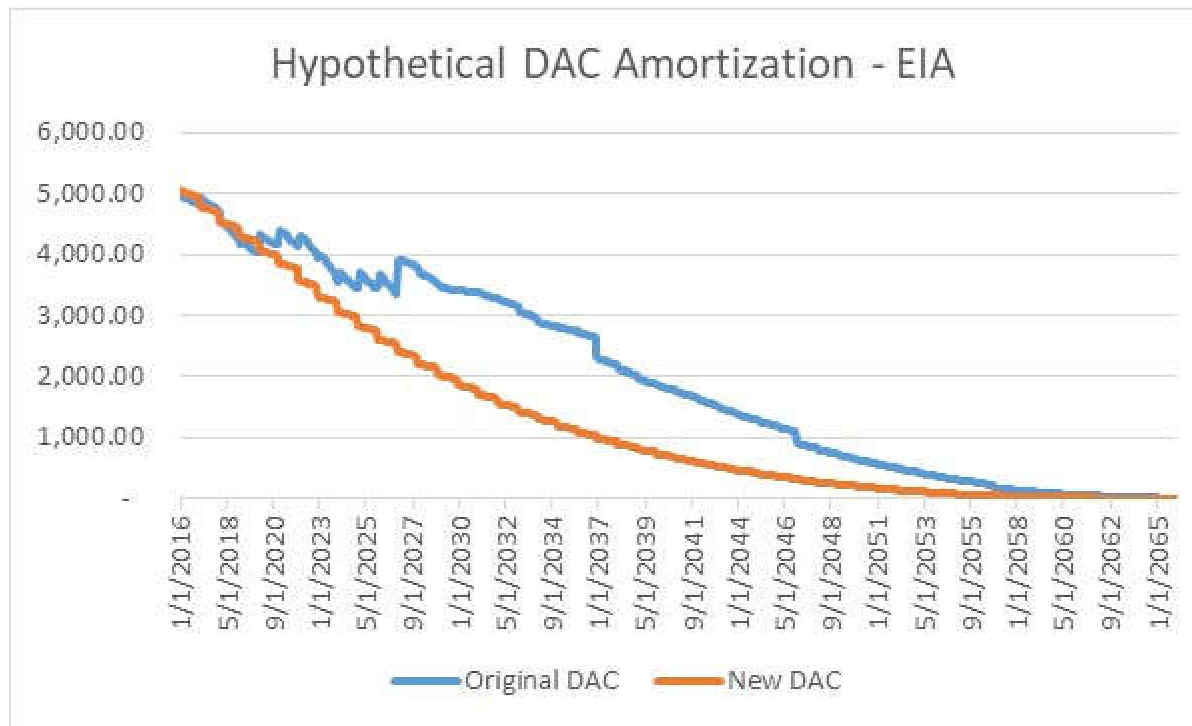
# Deferred acquisition costs

Earnings emergence driven by changes in DAC recognition





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## Deferred acquisition costs emerging observations

Offsetting impacts make predictions challenging

- DAC balances no longer growing with interest is unfavorable, though some extension of amortization horizon (particularly for limited pay) mitigates this
- Some additional unfavorability present in situations where negative DAC amortization is possible (such as negative gross profits in non-traditional business)
- Anecdotally, most ancillary balances such as VOBA being treated consistently with DAC, though we know of some exceptions to this, too (primarily due to materiality considerations)
- Guidance still isn't firm for other quantities such as VOBA that are currently amortized similarly to DAC


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# Market risk benefits

All GM*B types within variable and indexed annuities would be classified as market risk benefits and held at fair value

Fair value changes resulting from instrument-specific credit risk would be reported in Accumulated Other Comprehensive Income, instead of operating earnings


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# Market risk benefits

Many earnings and operational impacts likely with this change

- Earnings volatility will likely increase, if currently fair-valued rider benefits are predictive (note that there is no option to transition at current carrying value!)

- Variable Annuity writers may have an implementation advantage as they generally fair value at least some benefits currently

- It is possible some companies will try to demonstrate their Indexed Annuity benefits do not provide protection from “other-than-nominal capital market risk”, but this is likely a difficult argument


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## Enhanced disclosure requirements

From the summary included in the final update:

- *“The amendments require that an insurance entity provide disaggregated rollforwards of beginning to ending balances of the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities, and deferred acquisition costs.”*

- *“The amendments also require that an insurance entity disclose information about significant inputs, judgments, assumptions, and methods used in measurement, including changes in those inputs, judgments, and assumptions, and the effect of those changes on measurement.”*


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## Enhanced disclosure requirements emerging observations

Operationally challenging, but some benefits!

- The required rollforwards for traditional benefit liabilities have been fairly complex to implement, but produce tangible insights into reserve movements that had typically required a formula plug to tie under current GAAP

- Other disclosure requirements have presented questions around how to source elements, such as through the valuation engines or directly from the administrative system


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## Timing

- The original timing required public companies to report under the new requirements for fiscal years beginning after December 15, 2020. For most companies, this meant beginning in Q1, 2021
- This timing was delayed by one year in mid-2019, then an additional year in June 2020. The effective date for public companies is now for fiscal years beginning after December 15, 2022, practically speaking January 1, 2023
- Generally, one must show all values presented in the financial statements at the transition basis, so year-ends 2021 and 2022 would be expected to be calculated as well
- Early adoption is allowed and only requires one prior year's results to be presented (few, if any, companies plan to early adopt)


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# Early observations

- *(content pending)*


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