Insurance Revenue Recognition Redefined

Preparing for the Long Duration Targeted Improvement Standard

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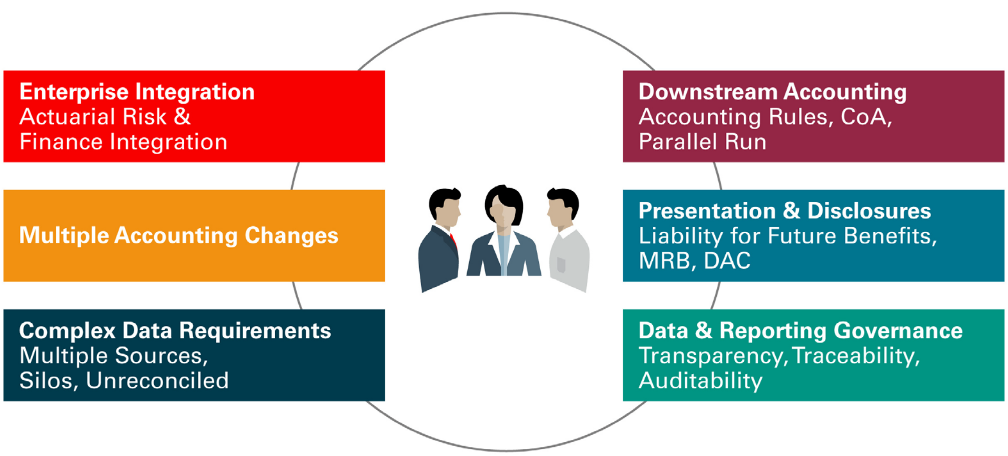
ASU 2018-12 for long duration insurance contracts (Long Duration Targeted Improvement, LDTI, or the standard), issued by the Financial Accounting Standards Board (FASB) in August 2018, is **undoubtedly a leap forward and a historic change** to insurance revenue recognition requirements.

The standard requires an overhaul of published financial statements, aiming to make both income statements and balance sheets more comparable within the industry, and achieve the much-needed transparency and clarity for all stakeholders. LDTI addresses improvements to the timeliness of measuring liability for future policy benefits for specified long duration contracts and makes changes to deferred acquisition costs accounting, cash flow assumptions, recognition of instrument specific credit risk assumptions, and disclosure requirements.

Implementation of the standard will require significant efforts and have a profound impact on various aspects of an insurance enterprise and its operating model. But, if viewed strategically, the standard presents a unique opportunity for insurers to align and transform disparate business processes and gain greater operational efficiency and insight.

How insurance organizations ramp up their systems, processes, and data will have a lasting impact in the short term and on how they meet the challenges of business modernization and enterprise analytics in today's digital economy, in the longer term.



Expectations from the Industry

BUILDING THE APPLICATION BRIDGE

The comprehensive requirements for measurement of liability for future benefits, discounted liability calculations, measurement of market risk benefits (MRB), and amortization of deferred acquisition costs (DAC), along with new statutory reporting and disclosures, will require insurers to apply major changes to processes and policies, thus strengthening the intersections of the accounting function with the Actuarial and Risk functions.

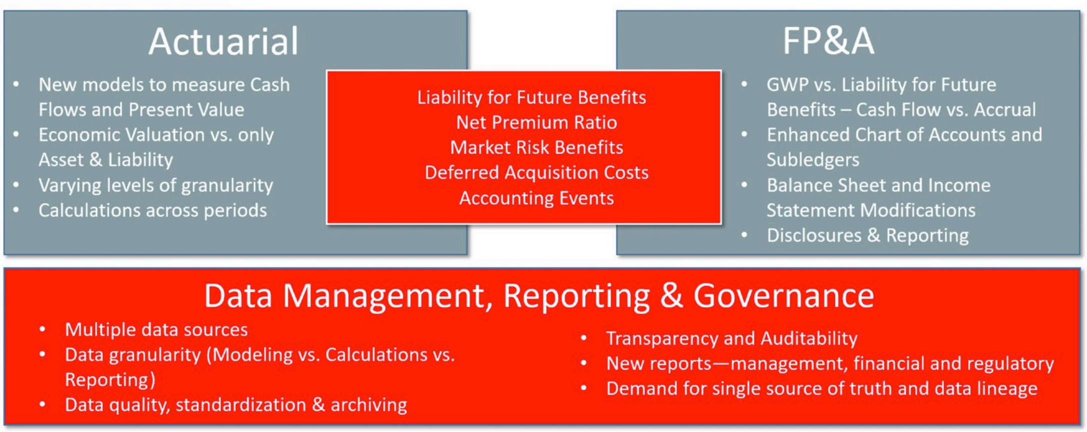
LDTI implementation requires not only working on enhancing existing capabilities, but also the realization of a completely new element; a "bridge" to enable a consistent and reliable connect between Actuarial and Finance functions.

On one side, the industry must address the changes required to their actuarial processes by:

- Enhancing the current actuarial models to estimate cash flows without diverse deviation provisions to evaluate liability for future benefits and gross premiums
- Creating new or enhanced models for fair value MRB accounting for contracts that expose insurers to other-than-nominal capital market risk
- Adding a higher level of granularity which relates to the concept of portfolio aggregation and cohorts
- Considering that output will be used for economic valuations and not just balance sheet and income statement reporting

On the other, the Financial Performance & Accounting function must:

- Produce an enhanced balance sheet and implement a new chart of accounts and accounting rules
- Recognize revenue on an accrual basis as insurance services are rendered instead of gross written premium on cash basis
- Maintain appropriate reconciliations and profitability projections between reporting periods
- Introduce a completely new calculation engine with the objective to bridge the actuarial outputs through to finance, while transforming and calculating the metrics required to produce the LDTI accounting, statements, and disclosures



The application bridge, after mining into the data produced by the actuarial models, must address the complex new capabilities required by LDTI through:

- Creating "cohorts" of contracts issued based on type and year issued
- Recognizing changes to liability for future benefits in a more timely manner at each reporting period, where assumptions for liability for future policy benefits are no longer locked in, and on a current basis
- Adjusting the projected liability, cash flows, and gross premiums of contracts as they change in estimation during the reporting period
- Simplifying the amortization of deferred acquisition costs

- Measuring all market risk benefits associated with deposit or account contracts at fair value
- Recognizing changes to fair value in other comprehensive income attributable to instrument-specific credit risk fluctuations
- Defining accounting events and associated balances from the calculations so these can then be used to produce appropriate journal entries and providing sub-ledger capabilities for an efficient and reliable flow of data to financial systems

IMPLEMENTING AN ENTERPRISE DATA FOUNDATION

Not only does LDTI require more granular and a wider spectrum of data from multiple sources to perform the complex calculations, but as financial statements get standardized and subject to investor and regulatory scrutiny, insurers must also ensure governance, lineage, and transparency across the entire data transformation and supply chain, from actuarial to accounting to reporting.

For reliable production of LDTI reports and disclosures, organizations must review their data platform with the objective to provide enhanced capability to aggregate, store, and manage data and results in a single environment. This data foundation ideally should not only serve the needs for LDTI computations, but also be readily scalable to other analytical uses cases across an insurance enterprise.

An ideal platform will serve as a single standardized source of analytical truth and can host a wide variety of granular, historic, and current data pertaining to Policies, Claims, Actuarial, Transactions, Reinsurance, Funds, Assets/Liabilities, Products, Market Data, Cash Flows, and more, while assuring transparency and lineage across the transformation flow. This will provide definitional consistency and alleviate issues around reconciliations that organizations with multiple source systems and operational data marts face, and that are significant inhibitors to achieving integrated risk and performance capabilities.

Further, this will allow faster ramp-up to future analytical, regulatory, and reporting requirements, as data and results can be reused across various functions without having to build physical integrations unlike between point solutions.

Finally, checks and balances must be an integral part of the platform, providing adequate control over data quality and its traceability from source to reporting, auditability into the calculations being performed, and governance to prove that these are done at the highest level of standards.

DON'T WAIT IN THE WINGS

Building the application bridge and enhancing the data platform requires significant effort and implementation time. Organizations now have the unique opportunity to leverage the transformation pushed by LDTI to build a modern insurance enterprise. A bifocal approach must be adopted in implementing a solution that allows compliance with LDTI, and at the same time establishes the base for a wider insurance modernization initiative.

A key tenet of LDTI is greater alignment between Actuarial Risk, Finance, and Compliance. The integration is not only at the level of processes, but, also at the data foundation level. A strategic approach to LDTI should not be adding a short-term solution to meet immediate needs, rather it should address the long-term challenges by building closer integration through a common analytical applications, data, and reporting platform.

The adoption of an integrated enterprise architecture will provide a higher return on investment by providing a platform for future expansion and the ability to extend the solution to cover other Finance and Risk analytical requirements, like IFRS 9, IFRS 17, Solvency II, CECL, and other regulatory requirements.

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