SOCIETY OF ACTUARIES
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Accounting for Ceded Reinsurance Under LDTI—Introduction

By Steve Malerich

Editor's note: The views expressed in this article are those of the author and do not necessarily reflect the views of the author's firm.

Since the release of Accounting Standards Update 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI), there have been many questions and much discussion about accounting for reinsurance. I expect that further guidance from the American Institute of Certified Public Accountants (AICPA) will answer some questions but leave many unanswered. In this and future articles, I will offer my insights into some of these concerns.

REINSURANCE PROVISIONS AFTER LDTI

GAAP provisions that directly address ceded reinsurance saw very little change under LDTI.

Recognition

LDTI does not alter the assessment of risk transfer (ASC 944-20-15-1B and several other paragraphs within subtopics 944-20 and 944-40) or the distinction between long- and short-duration reinsurance contracts (ASC 944-20-15-2, 15-34 and 15-34A).

LDTI does add to reinsurance the same new market risk benefit (MRB) classification as for direct annuitization, death or other insurance features. Any such feature must be evaluated first as a possible MRB and, if it's not an MRB, under the derivative and embedded derivative criteria of topic 815 (ASC 944-40-25-40). If the reinsurance of such a feature is not an MRB, a derivative, or an embedded derivative, then it is accounted for as an insurance feature under the same guidance as accounting for the direct feature (ASC 944-40-25-41).

Deferred Acquisition Costs

LDTI does not change the requirement that allowances for acquisition costs be applied such that "net acquisition costs are capitalized …" (ASC 944-30-35-64). Only the clause describing amortization is amended to reference the updated deferred acquisition costs amortization requirements.

Cost of Reinsurance

LDTI does not change any of the provisions directly addressing the cost of reinsurance.

The requirement that a "cost to be amortized" include "The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts" (ASC 944-605-30-4) prevents "immediate recognition of gains when the reinsurance contract is not a legal replacement of one insurer by another" (ASC 944-40-25-33).

For reinsurance of long-duration contracts, any such "cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long-duration or over the contract period of the reinsurance if the reinsurance contract is short-duration" (ASC 944-605-35-14). "The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts" (ASC 944-605-35-15).

Reinsurance Recoverable

LDTI does not change any of the provisions directly addressing the reinsurance recoverable.

"Reinsurance recoverable" is defined to be "All amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, or policy benefits" (ASC 944-40-20). "Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims … and future policy benefits) relating to the underlying reinsured contracts" (ASC 944-40-25-34). As with the cost of reinsurance, "Assumptions shall be consistent with those used in estimating the related liabilities" (ASC 944-40-25-34).

INDIRECT CHANGES

The lack of explicit changes to reinsurance valuation provisions does not mean that reinsurance valuation is unchanged.

Though there is no reference to the method of amortizing the cost of reinsurance, the reference to consistent assumptions means that its amortization must align assumptions with the updated assumption requirements for the reinsured contracts.

With respect to the reinsurance recoverable, the references to consistent manner and assumptions mean that measurement must align with both the updated manner and the updated assumptions of the underlying contracts.

To assess indirect effects on reinsurance recoverable amounts for paid claims, unpaid claims and policy benefits, it is necessary to consider each of these direct liabilities separately. Indirect effects on amortization assumptions for the cost of reinsurance will follow the changes to assumptions for direct liabilities.

Paid Claims

Since paid claims have been settled with the policyholder (or a designated beneficiary) there are no "liabilities … relating to the underlying reinsured contracts." LDTI does not change the measurement of reinsurance recoverable for paid claims.

Unpaid Claims

LDTI does not change any of the provisions for unpaid claims and claim adjustment expenses (ASC 944-40-25-1), whether reported or unreported (ASC 944-40-25-2), or the requirement to accrue these liabilities when insured events occur (ASC 944-40-25-9). Subsequent measurement is also unchanged, "Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made" (ASC 944-40-35-1).

With no change to the unpaid claim liability provisions or to the reinsurance provisions addressing consistent manner and assumptions, it is generally true that the measurement of reinsurance recoverable for unpaid claims is also unchanged. There is, however, an exception.

For some contracts, claims are settled over an extended period and future payments are contingent upon future developments. Disability income and long-term care insurance are two products that commonly include such contingent payments. In considering the relationship between unpaid claim liabilities and other contract liabilities, principally the liability for future policy benefits, the AICPA has concluded that amounts subject to future contingencies are properly classified as future policy benefits —not unpaid claims—even if the contract is in a current claim status.

Considering the new AICPA guidance, some amounts that were calculated and reported as unpaid claim liabilities will now have to be calculated as part of the liability for future policy benefits (or additional liability for other insurance benefits if the contract is universal life). Accounting for the corresponding reinsurance

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recoverable amounts, therefore, will have to change along with accounting for the underlying reinsured contracts.

Future Policy Benefits

For reinsurance recoverable relating to future benefits, consistent manner and assumptions will require a net premium method with retrospective remeasurement for assumption updates, including the substitution of actual experience for expected, whenever those are applied to the direct liability.

The new requirements complicate the relationship between a direct liability and the corresponding reinsurance recoverable. Depending on how a company applies the new requirements, accounting for reinsurance recoverable might or might not align results consistently with cash flow effects. Having considered the more complex dynamics, the AICPA is considering additional guidance about the application of retrospective updates, discount rates and constraints to reinsurance recoverable balances.[1] Beyond this, there is no general guidance about the measurement of net premium reserves for reinsurance recoverable.[2]

Cost of Reinsurance

Unlike reinsurance recoverable, accounting standards define only “part of” the cost of reinsurance. That reference implies that there is (or might be) more cost but there is no codified description (or other general guidance) of what that might be.

The only explicit requirement for amortizing the cost of reinsurance is to use assumptions “consistent with those used for the reinsured contracts.” Accounting standards say nothing about the manner of amortizing the cost of reinsurance.

Under LDTI, companies will have to update assumptions periodically with changes in assumptions of the reinsured contracts. Otherwise, companies must consider broader accounting principles to determine the most appropriate way of amortizing this cost, including the manner of applying assumption updates.

A FRESH LOOK

The dynamic assumption update requirements of LDTI will affect the reported performance of business that is reinsured. When added to existing reinsurance accounting practices, this could result in reinsurance effects on net income that are consistent with—or dramatically different from—its effects on net cash flows. In the next article, I will take a fresh look at reinsurance accounting, as if there were no precedents about how to interpret and apply the requirements described in this article. ■

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ENDNOTES

1 Draft guidance was made available for public comment on July 24 with comments due Sept. 25.

2 Audit firms may provide more detailed guidance but that is outside the scope of this article.

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Survey Results on COVID-19 Effects on VA Business

By Shari Lu, Michael Beck and Dave McLeroy

At the time of setting their assumptions for year-end 2019, no one had predicted that in the following six months a virus would have spread around the world causing the death of over half a million[1] people nor the economic volatility and disruption that accompanied it. This brief article provides the results from a survey conducted by KPMG LLP with variable annuity (VA) writers and a discussion of what companies are considering when it comes to assumptions for the rest of 2020.

SURVEY RESULTS

Participants were asked various questions regarding preparedness and expectations in light of COVID-19 for variable annuity business. The survey results reflect the views of 21 respondents who represent over 70 percent of VA market share. Below is a summary of the results.

Hedge Performance and Strategy

All participants responded that their hedging strategy performed as expected during Q1 2020. While there was some disconnect between liability and asset movements given the magnitude of market movements, no respondent indicated an intention to change their hedging strategy at this time.

Fund Movement between Separate and General Account

Few companies experienced increased fund movement between the separate account and the general account with the down market. All companies that saw a change expect the behavior

to revert to normal levels later in 2020 in line with market movements.

Policyholder Lapse Rates

Most participants did not note an increase in actual lapse experience in Q1 2020. One company did experience an increase in lapses and another mentioned that it was unable to assess the impact. When asked about the remainder of 2020, only three companies expect an increase in lapse rates due to COVID-19.

Off-cycle Updates to Liability Assumptions

Three companies either have made or are planning on making changes to their economic assumptions (e.g., long-term interest rate assumption), and another company is reviewing all long-term assumptions. Other than these four companies, no company responded that it was planning an off-cycle assumption update; rather, they will be following the normal timing for assumption unlocking.

RBC Ratio Movement

Around 40 percent of the companies had a decrease in their RBC ratio during Q1 2020, while 50 percent of the companies saw the ratio remain stable and 10 percent of companies saw an increase in the RBC ratio. The underlying question in the survey grouped the RBC ratios within bands spanning a 50 percentage point range, so those companies that remained stable may have increased or decreased within their initial range.

Counterparty Defaults in Bonds or Reinsurance

In Q1 2020, only one participant observed an increase in counterparty default rates from bonds. No companies observed an increase in the defaults of reinsurers. However, seven companies expect to see an increase in counterparty default rates in the remainder of 2020 compared to prior estimates.

Management Actions in Response to COVID-19

Around 50 percent of the participants responded that they have taken or will be taking new management actions which were not previously planned earlier in the year. This includes but is not limited to, changes in pricing, product de-risking, change in hedging portfolios, and temporary changes in contract features to support policyholders.

Most participants did not note an increase in actual lapse experience in Q1 2020. One company did experience an increase in lapses and another mentioned that it was unable to assess the impact.

CONSIDERATIONS FOR 2020

As we can see from the results of the survey, many companies do not intend to make off-cycle adjustments to their assumptions. Are they right? There are a number of items to consider in answering this question.

Does Experience Demonstrate a Need for Change?

So far, companies are not seeing a material increase in the number of death or surrender claims. This may be because the exposure companies have in their insured population is different to the excess mortality experienced in the wider population. Alternatively, it might be a delay in the reporting of deaths and the collection of information relating to the cause of death. Experiencing no change in one's data does not preclude the possibility that there might be an increase in the future.

What Does the Future Hold?

While there have been increased deaths in the short term which can be measured, the longer term is less obvious. The mortality impact could continue to be elevated, revert to the mean or possibly move below the mean before reverting back to the mean again as deaths from higher risk groups are accelerated. At this time it is not clear what the outcome will be as it relates to COVID-19. Another factor to consider is the development of a vaccine or therapeutic treatments and how these might affect the mortality associated with COVID-19. These uncertainties around the future path of long-term experience will make updating assumptions, especially mortality, difficult for 2020 year-end.

What Role does Economics Play?

In March 2020, the Federal Reserve cut the federal funds rate to near zero. For those VA riders that are currently valued under the fair value methodology (i.e., GMWB and GMAB), this drop in rates materially increased the reported GAAP reserves as of the end of Q1. While there is some offset due to the increase in corporate spreads in the short term, we have seen that these spreads already decreased during Q2 while the Federal Reserve is signaling that it will maintain interest rates at the current levels for the next few years. It is likely that the low interest rate environment question will be a part of the business environment longer than expected 12 months ago. For SOP 03-1 reserves, the mean reversion long-term returns are more subjective and may need more focus in assessing whether they should be changed.

The speed at which the economy rebounds may have additional effects on certain policyholder behavior assumptions, namely utilization and lapsation. If there is a persistent decrease in the economy, the need for policyholders to access money may cause an increase in partial withdrawal and lapsation, or an increase in the overall utilization which may lead to a further increase in reserves.

Ultimately, company actuaries and management will have to decide what their view of the future is, based on the data available both internally and externally. While they may not elect to make changes in assumptions given the uncertainty of the current environment, they can provide additional disclosures to users of financial statements. Additional disclosures to demonstrate the sensitivity of results to certain movements where there is uncertainty relative to the current environment could be important for management, shareholders and regulators. ■

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ENDNOTES

1 544k as of July 8, 2020 based on WHO statistics.

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Financial Reporting Research Update

By Mark Walker and Ronora Stryker

Research is a primary mission of the Financial Reporting Section and a significant use of our section dues revenue. Here is an update, as of July 2020, on projects in process and those recently completed.

CURRENTLY IN PROCESS

"Mortality by Socioeconomic Category in the United States." The purpose of this study is to construct a set of life tables for groups of counties based on their relative socioeconomic position. This is entering the late stages as preliminary results are currently being reviewed.

"Mortality Improvement Trend Analysis." This research examines the key drivers of mortality improvement and how they vary. Work has yet to begin on the project, as the data set to be used in the study has not been released.

RECENTLY COMPLETED

"Living to 100." This research initiative focuses on aging—increases in survival rates and the resulting increase in aging populations—together with its implications to social, financial, retirement and health care systems. It involves a symposium which was held in January and generates a lasting body of research to educate and aid individuals and policymakers in addressing the potential needs and services of the future advanced-age populations. Recordings of the sessions and research papers presented at the event are now available in an online monograph. *https://www.soa.org/resources/essays-monographs/2020-living-to-100/*

"Delphi Study of Economic Variables." This study uses a Delphi Study framework to gather insights on the thought processes experts employ to estimate future values of economic variables. *https://www.soa.org/resources/research-reports/2020/real-time-delphi-study/*

"Simplified Methods for Principle-Based Reserve Calculations." This project investigates a simplified approach for determining principle-based reserves. *https://www.soa.org/resources/research-reports/2020/simplified-methods/*

"Macroeconomics-Based Economic Scenario Generation." This project intends to find a practical way to improve economic scenario generators by studying the causes of economic development, economic volatility and capital market volatility. *https://www.soa.org/resources/research-reports/2020/macroeconomics-based-esg/*

"Simplified Issue Underwriting." This research explores the application of simplified issue underwriting in the life insurance industry. Among the areas studied are the definition, developments, characteristics, challenges, current practices, assumptions and data elements for simplified underwriting. *https://www.soa.org/resources/research-reports/2020/simplified-issue-underwriting/*

"Modeling and Forecasting Cause-of-Death Mortality." This study develops mortality projection models and produces cause-of-death mortality forecasts. *https://www.soa.org/resources/research-reports/2019/cod-mortality-forecasting*

"The Application of Credibility Theory in the Canadian Life Insurance Industry." This survey of credibility practices of Canadian life insurers compares and contrasts credibility methods used by the companies. The Financial Reporting Section contributed to the funding for this project. *https://www.soa.org/resources/research-reports/2019/application-credibility-theory/*

"A Machine Learning Approach to Incorporating Industry Mortality Table Features in Mortality Analysis." This research applies a machine learning approach that enables a practicing actuary to incorporate key industry mortality table features into insured mortality analysis. *https://www.soa.org/resources/research-reports/2019/2019-machine-learning-approach/*

"The Use of Predictive Analytics in the Canadian Life Insurance Industry." This project surveys Canadian life insurers on the use of predictive analytics in practice. The Financial Reporting Section contributed to the funding for this project. *https://www.soa.org/resources/research-reports/2019/predictive-analytics-canadian-life-insurance/*

REQUEST FOR RESEARCH PROPOSALS

Do you have an idea for a research topic you would like to see the Financial Reporting Section consider for funding? If so, we want to hear from you! For more information, please contact Mark Walker or Ronora Stryker. ■

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