Insights for the future

Preparing for LDTI

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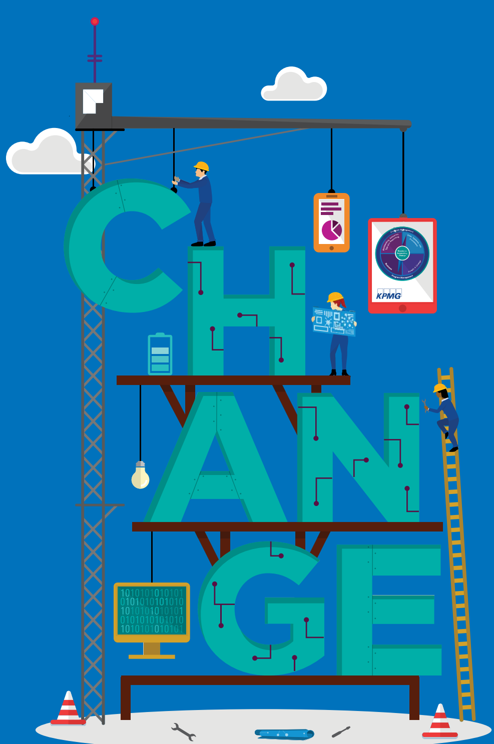
Since the issuance of ASU 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts* (LDTI), there has been a significant increase in activity from insurers impacted by the standard. Insurance companies are gearing up their change programs and thinking with purpose about how they should implement the new standard.

At this point, it is important to pause and consider how to respond to the challenge of the new reporting standard. Based on KPMG professionals' experience working with insurers in the U.S. and around the world on a wide range of complex transitions, such as IFRS 17, Solvency II implementation, postmerger integration, and a variety of finance and actuarial transformation initiatives, we offer our thoughts on possible next steps for the future when planning for LDTI implementation.



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Our present state

With a large percentage of insurers currently focused on the assessment phase of LDTI, many KPMG professionals are engaged in discussing implementation plans with a number of clients across our practice. These plans range from an assessment of the full impact of LDTI on groupwide processes to selected assessments of specific topics, sometimes at the group level alone or for a few selected products. Many industry leaders are already planning how they will operationalize the new standard while there are a number of insurers delaying their preparations following FASB's proposal to defer the effective date of LDTI.

The FASB LDTI standard is a result of the FASB and IASB's divergence related to accounting for insurance contracts. Although LDTI and the IASB's IFRS 17 standard apply different technical concepts, the implementation challenges that arise as a result of these accounting changes are similar. As a result, we have much to learn from our IFRS 17 experiences gained from assisting our global insurance clients across many dimensions of implementation. For example, during our IFRS 17 journey, we engaged in a series of dialogues with financial reporting executives at large insurance companies on what the insurance industry can learn from previous change programs. We believe there is much to be gained for the industry as a whole—from collaborating and sharing leading practices to discussing the potential implementation pitfalls and how to avoid them.

LDTI has the potential of creating greater transparency and comparability in financial reporting for the U.S. insurance industry. It is expected to arm financial statement users with better and more timely information about the performance of long duration contracts issued by insurance companies.

LDTI provides an opportunity for greater standardization and improved process efficiency across large U.S.-based insurance organizations, including the potential to deliver greater consistency between local and group reporting and between different operating units. Reasons for this include:

— LDTI's requirement for insurers to update assumptions for liability measurement at least annually

— The requirement for the liability discount rate to be based on market-observable economic conditions.

Additionally, LDTI will impose greater consistency in the measurement of market risk benefits and will simplify deferred acquisition cost amortization via a constant-level methodology. The desired transparency will also be achieved through expanded disclosures.

The impact of these changes is significant, and as we think through the steps to establish new processes, the extent to which the production of metrics (such as cash flows, discount rates) can be aligned offers important efficiencies.

But the implementation of LDTI also has the potential to drain large amounts of resources, both time and money, over an extended period. Carefully establishing a project plan and timeline for the implementation of LDTI—and executing a framework by which efforts are tracked against progress—will be key to ensuring resources are applied effectively.

> "There is much to be gained for the industry as a whole, from collaborating to sharing leading practices to discussing the potential implementation pitfalls and how to avoid them."

More than just compliance

For some, LDTI arrives at a time when the organization was already engaged in another large transformation effort, whether it was business, IT, actuarial, accounting, data modernization, finance or cross-functional. For others, LDTI presents an opportunity to transform existing finance and actuarial operations, data management and IT systems, which will drive greater efficiency, transparency and value within the organization.

Despite the prospect of transformation, a large-scale accounting change program—that some may consider a compliance exercise—will have to compete with other priorities for funding. The search for growth, the need to innovate, renewed focus on costs and efficiency, and the requirement to comply with other new accounting standards and regulations that have earlier deadlines may lead to significant competition for resources, both human and monetary. What we have learned from other change programs is to keep the end state in mind when thinking about the reporting requirements and to consider the data requirements—and whether data is properly captured and subject to internal controls.

Oftentimes when we are encountering change, we are focused on looking at what's in front of us. This is one time that we will want to focus on what's around us, above us, and below us, so we can engage with the appropriate stakeholders, with the acknowledgement that when you engage in a change program, you are really transforming everything around the process.

Learning from past mistakes

> "We have to move forward quickly. Now is not the time to put off planning. There is no time to rest."

What is to be done? First, the insurance industry cannot afford to put off the task of planning another day. Nobody can afford to stand still. Instead, executives should start by examining what has worked well in previous large-scale projects and how previous mistakes can be avoided this time around. Of course, there is no single answer, as each organization's situation is unique and each has a different starting point for its journey. There is no time to rest and the worry is that organizations that put off the effort now will fall behind. Falling behind risks failed implementation projects, potential restatements, and the need for internal control remediation.

At any point in the implementation journey, organizations are going to experience time challenges. Interestingly, we have learned from our experiences with our global clients that organizations furthest along with their IFRS 17 implementation projects are the ones feeling the time challenge the most. Why might that be? One needs to scratch the surface a little—the more organizations do, the more they realize how hard the task is, the far-reaching organizational impacts of the change, and how much more work is involved than they first thought.

Time management is critical to any implementation project. It is important to remember that as you establish your project plan, you allow time to:

— Get things right: Intensive test runs, dry runs and parallel runs will reveal issues that require resolution

— Get stakeholders acclimated to the changes: People will need to be educated about the impacts of change and learn how to do their job in the "new world"

— Understand the impact of the accounting change on the organization's results: Not only will organizations need to "tell their story" upon the adoption of LDTI, they should consider the need for new and/or revised key performance indicators, the impact on non-GAAP measures—such as operating income—and potential changes to management reporting—including those related to forecasting and monitoring financial results with impacts on employee compensation metrics.

Insights for the future

Based on our experience in working with insurers on large accounting change programs, we have found a number of lessons in common that should prove useful for the implementation of LDTI. These include:

1. **Good leadership is a key element of a successful project.** This requires a commitment to a vision of what the organization's systems and processes should look like at the end of the program. It requires the organization's leaders to stay involved in the project from beginning to end and to be open to new ideas throughout the process. Organizations should also consider the Project Management Office (PMO) function. Often, a PMO function is essential to keeping

a project on time and on track. Some organizations have professional PMOs on staff that can be assigned to various projects. Others may want to consider appointing a PMO within a key functional area—such as accounting, actuarial or IT. Other organizations may want to consider outsourcing the PMO function to a consultant.

2. **Recruit dedicated staff.** In our experience, the single biggest success factor for a large-scale change program 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's important to consider human resource needs now. Globally, we have seen qualified insurance resources become scarce since IFRS 17 was issued. As more and more companies proceed down the implementation path, we expect resources to become more difficult to secure—and more expensive. Companies should also consider the types of resources needed. We've seen some companies back-fill day jobs with temporary resources to free up permanent resources to help run their implementation programs. We've seen other companies consider teaming with a consultant—such as KPMG—to supplement their needs. In relation to IFRS 17, we've also seen some organizations—particularly smaller organizations or those applying IFRS 17 for compliance purposes only—consider managed services solutions.

3. **Do not 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 will be a multidisciplinary effort. Remember that the analysis and design of the solutions need to be seen through all of these lenses. Take time to analyze technical aspects of complying with the new requirements, in particular as principles and their interpretation are applied for the first time. Ensure the methodology chosen can be applied time and time again. It's important to embed processes within the organization as well as consider the impact on internal controls, the close process and the tax department.

4. **Allow enough time to prepare the groundwork and formulate the plan at the beginning of the process—and get it right.** Getting started can be a challenge (see next page). The start of the program can appear daunting, but it would be worse to find out late in the implementation timeline that the organization could have fundamentally rethought some of its current processes. A comprehensive and detailed gap analysis is often the most critical project element to get right. A solid gap analysis should consider accounting policy, actuarial methodology, data requirements, system limitations and potential internal control changes.

5. **Avoid multitasking. Take the process one step at a time, test and learn, and then take a new step.** Companies should not design massive changes to systems and processes before knowing what the organization is aiming to achieve at the end of the implementation program. It may be necessary to back up and change direction after gaining fresh insights of what needs to be done—and this is what we mean by test and learn. Organizations should also involve their auditors along the way—to assess accounting policy choices, actuarial methodologies and confirm key decisions with management.

6. **Do not allow the LDTI program to become so big that people lose sight of its objective.** This requires a clear vision towards the objective that the organization is working toward and rigorous project management over a long period of time to prevent "scope creep".

7. **Developing a "living" plan, including realistic timelines, clear accountabilities and sufficient time to test and learn, forms an effective blueprint for success.** Consider using two versions of the project plan, one as a high-level multiyear milestone plan for communication to stakeholders such as audit committees, and one at a more detailed level for day-to-day operational management of the project. The plan must be achievable and continuously refined with formal tracking and monitoring. We recommend revisiting the details at least every two weeks or else it will quickly become redundant. Having a large-scale physical representation of the plan clearly visible for the project team (e.g., on brown paper) will help to keep it alive. The plan should also incorporate internal and external human resource allocations and budgeted external spend. Budgets and resource needs can change based on unexpected challenges, and therefore, the plan should be updated periodically.

8. **Changes in circumstances are inevitable.** Given LDTI's implementation timeline, it is likely that new talent will need to be brought in to avoid change fatigue—and some of those who are involved at the start of the project will need to move on to new roles before completion. Careful thought needs to be given to documenting key decisions and working assumptions and to forming a consistent set of views, without becoming too rigid.

> "Implementing LDTI will be a multidisciplinary effort."

Getting started—ask the right questions

The implementation of LDTI seems daunting and begs the question, where do I begin? The following questions should give you a good starting point to generate discussion within your organization and get the ball rolling!

Twelve questions to kickstart your transition to LDTI

1. **Which long-duration contracts in your portfolio are subject to LDTI?**
   LDTI impacts a broad range of long duration life and A&H contracts. Determining which products are impacted is critical to determining the effort needed to implement LDTI.
2. **Do you have sufficient resources and budget?**
   Can you build your initial budget and resource estimates by extrapolating from previous change programs? Are there other transformational activities you should consider in developing a comprehensive accounting change budget?
3. **What big changes have you navigated recently?**
   Are there synergies you can unlock? For example, are there recent valuation or IT system implementations you can leverage? Are there in-flight projects that you should consider aligning with your LDTI implementation?
4. **How granular will your new required LDTI disclosures need to be?**
   You might need to report at a more detailed level. You will want to consider how these new disclosures help you tell your story, including how these disclosures articulate back to your MD&A, press releases, and analyst and investor presentations.
5. **Will LDTI make your financial results more volatile?**
   What accounting policy choices could you make to reduce volatility? How will you explain changes in results to your investors and stakeholders? How will you use dry runs and parallel runs to develop your story?
6. **How will your KPIs change?**
   How will you help your investors and stakeholders understand these changes? You will need to consider the types and levels of education necessary to help various constituents get up to speed.
7. **Are you using discount rates from an era of higher interest rates?**
   Reserves could increase and reduce surplus if a large amount of business was written prior to 2008–2009.
8. **How will LDTI affect the way your assets and liabilities interact?**
   If your liabilities shift, you may need to change your asset mix and/or consider hedging strategies.
9. **What other accounting changes need to be considered?**
   Have you explored your accounting policy options under both LDTI and the new Financial Instruments standard (ASU 2016-01) to better align both sides of your balance sheet? If you have foreign territories subject to IFRS 9 and 17, have you considered aligning your accounting change projects for maximum efficiency and effectiveness as they relate to stand-alone and group reporting?
10. **How diverse is your insurance portfolio?**
    The more lines of business and product variations you have, the more time you're likely to need to implement.
11. **Is your historical data easily available?**
    If not, your transition options may be limited.
12. **Do you have significant reliance on data from reinsurers or third-party administrators?**
    Coordination with third parties such as reinsurers or TPAs will be critical to obtaining all the data necessary to comply with LDTI.

KPMG

Mapping your insurance change program

Experience indicates that in order to digest the implications of changes being brought forth by LDTI, organizations will have to address and respond to many questions.

Our insurance accounting change methodology acts as a compass to help ensure answers to these questions are focused and well-targeted and take into consideration program interdependencies and broader business implications.

If implementation of LDTI is to reach a successful outcome for your organization, we believe that it needs to be seen as more than just a compliance exercise. This means combining multiple processes into a common program, identifying linkages and addressing dependencies across the business in a logical sequence and thinking strategically about the possible effects on the organization and its stakeholders.

Our flexible approach offers our clients a well-established and adaptable methodology to tackle changes that otherwise might appear daunting. Our methodology groups activities into four manageable phases:

1. Assess the change
2. Design your response
3. Implement your design
4. Sustain your new practices, securely embedding them in business as usual.

Accounting, modelling & reporting

— ASU 2018-12 contains a number of accounting and actuarial policy choices and key judgements within interpretation, application and operationalization. These will impact external reporting, management reporting/planning, and actuarial.

— Making the "right" choice means clearly defining priorities, testing the financial and operational implications, and revisiting those choices and judgments in light of findings.

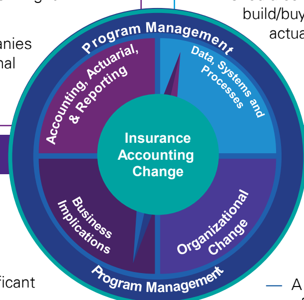
— The standard introduces more granular disclosure requirements. Companies will need to comply, but more importantly reconsider internal and external reporting and analysis as well as impact on internal and external KPIs.

Data, systems & processes

— Additional data points and increased granularity are required to comply with ASU 2018–12 at transition and going forward. Sourcing complete and accurate disaggregated data in a timely manner will prove a unique challenge for companies implementing ASU2018-12.

— As opportunities to adopt more consistent systems and processes arise, companies should consider opportunities to maximize value and minimize IT spend (e.g., centralizing build/buy decisions and implementation efforts for capturing actual experience in actuarial systems).

— Automation of certain manual processes may be required due to resource constraints and increased risk of error. The priorities will vary, but increased consistency creates opportunities for alignment.



Business implications

— ASU 2018-12 will create accounting mismatches between investments and reserves. In response, companies will be looking to revisit existing contracts and their pricing strategies. Companies will need to understand the impact on their products and businesses.

— The use of non-GAAP measures for reporting results has received significant attention by the SEC. While use of non-GAAP measures is permitted, the application and strategic use will need to be reevaluated.

— Additional implications are expected with internal controls and potential adjustment to investment/hedging strategies.

— Where internal remuneration is impacted by U.S. GAAP results, a reevaluation of policies is also in order.

Organizational change

— An appropriate program structure will drive decision making, improve efficiency and help ensure accountability. Companies will need to strike the right balance between centralized and de-centralized structure to enable successful programs at subsidiaries.

— A roadmap will help stakeholders understand the scope of the project, timing of activities, and provide a basis for detailed action plans. Companies need to incorporate industry lobbying efforts and accelerate their programs to strategically address client needs.

— Appropriate governance (e.g., status update meetings, steering committee involvement and project risk management) are vital to the success of a large-scale accounting change implementation.

Next steps in transformation

There is, in sum, much to be learned from an organization's experience with previous large accounting, finance and/or actuarial transformation projects. Organizations should take these lessons to heart and apply the learnings in developing their LDTI implementation plan. We strongly recommend that every insurer carefully examine their large transformation projects from the past 5 to 10 years and consider what worked well for them, and be honest about what did not, then use these insights as guideposts for the LDTI journey. For those organizations in the midst of a large-scale transformation project(s), it's important to align those projects with the LDTI implementation plan—to limit transformational rework and to plan for availability of adequate resources and budget to complete all projects in the pipeline.

Our overarching message is to be extremely conscious about the working assumptions and choices that are made at the start of the project and their rationale. A clear vision of the end state is a key factor to project success. Companies should then test and learn as they steer a course to implementation over the next two to three years. This challenge will require insight, vision, experimentation, teamwork, and consistency over a long period of time.

KPMG professionals can help you navigate the complex challenges presented by LDTI—and other accounting changes as applicable—by leveraging a tailored methodology to consider the impact for your business in a structured way, providing advice that is tailored to your business and your strategic objectives.

Contact us

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