ENERGIZING the Industry

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# Advanced Topics Related to Valuation—I’m an IFRS, I’m a PBR, I’m a GAAP

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THE ELEVENTH ANNUAL INTERCOMPANY LONG TERM CARE INSURANCE CONFERENCE

ILTCI

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# Agenda

- Brief discussion of GAAP, IFRS, and PBA
  - Adequacy testing, aggregation, long- v. short-tail, discount rates, PADs, LTCi, etc.
- Compare and contrast these accounting methods for various topics
- Q&A from list of selected topics….or others

# Topics to Be Covered

1. How are limited-pay contracts handled?
2. How are tax reserves impacted?
3. Should ARLs still be held if he p/h is disabled?
4. What are the implications for a rate increase?
5. Where is conservatism to be included?

# Topics for a Vote

1. How is waiver of premium handled?
2. What if assumptions change?  Credible experience?
3. What are unique issues with reinsurance?
4. When should stat ALRs be increased/decreased?
5. What about deficiency or loss adjustment reserves?
6. How is purchase accounting viewed?
7. Any issues for ROP, NF, survivorship riders?
8. Conservatism and capital requirements

# GAAP Overview

- Primary guidance provided by ASC 944-20 (formerly FAS 60)
- Matching principle
- Long-duration contracts
- Benefit (Active Life) Reserve
  - Net Level Premium method
  - PV Future Benefits less PV Future Net Premium
  - Best estimate assumptions plus Provision for Adverse Deviation (PAD)
- Deferred Acquisition Cost (DAC)
  - Amortize deferred expenses in proportion to premium
- Benefit Reserve and DAC assumptions are locked-in at issue
- Claim Reserves
  - Best estimate assumptions
  - Practices on lock-in, PADs, cohorts of claims by incurral year

# GAAP Overview (Cont'd)

- Reserve Adequacy
  - Contract groupings
- DAC Recoverability
  - For current year's issues
  - Assumptions: Best estimates
- Loss Recognition Testing
  - For all inforce business
  - Assumptions: Best estimates for Gross Premium Valuation (GPV)
    - Future expected rate increases
    - Future morbidity/mortality improvements
  - Net GAAP Liability (Benefit Reserve less DAC) should exceed GPV
- Impact of rate increases on valuation
- Paragraph 35 and Paragraph 37 premium deficiencies
- AICPA TPA TIS Section 6300 guidance on prospective unlocking

# Principle Based Approach (PBA)

- PBA in a nutshell
  - Stochastic Projections
  - Assumptions
  - Modeling Differences
- Basic Tenets of PBA for Health / LTC
  1. Capture Benefits and Quantifiable and Material Risks
  2. Use Risk Analysis and Risk Management Techniques
  3. Risk Assessment and Models Consistent with Company's Overall Risk Assessment Process
  4. Utilize Company Experience Based on Relevance and Credibility
  5. Appropriate Conservatism Recognizing Statutory Solvency Objective
  6. Reflect Risks and Risk Factors in Reserves and RBC

# Principle Based Approach (PBA)

- Life Insurance Trail Blazers
  - Status Update - NAIC VM 20 Impact Study
  - Solvency Modernization Initiatives
  - Differences and Similarities to LTCi

- LTC Status Update
  - On NAIC Priority List
  - Modeling Prototype Near Complete
  - Refinement Needed on Management Action and Assumptions

# Principle Based Approach (PBA)

- How will life be different in a PBA environment
  1. Mechanically, stochastic projection analysis
  2. If like life insurance, will likely be a deterministic floor as well
  3. Deterministic Test?
  4. Conditional Tail Expectation (CTE) Calculations for reserves and capital?
  5. Management Action?

# International Financial Reporting Standards (IFRS)—Basics

- Applies to all insurance and reinsurance contracts (<u>not</u> insurance enterprises)
- Explicitly defines insurance contract
- Recognition of an insurance obligation when you become party to a contract (could be before coverage period starts)
- Contract boundary defined to measure net cash flows
- Building-Block Approach (next slide)
  - Acquisition Costs included in net cash flows (no separate DAC)
  - Subsequent measurement reflects changes in estimates
- Level of measurement
  - Present value of fulfilment cash flows – portfolio level
  - Residual margin –grouping by portfolio and within portfolio, by similar date of inception and coverage period
- Modified Approach (Premium Allocation Method) for Short Duration Contracts
- Reinsurance--cedant does not offset reinsurance assets against insurance liabilities
  - Reinsurance assets measured using same basis as insurance liabilities
- Financial Statement Presentation—margin presentation approach

# International Financial Reporting Standards (IFRS) Proposed Measurement Model –3 or 4 Building Blocks

| IASB Preference (modified to exclude day one gains) | FASB Preference (modified to exclude day one gains) |
|---|---|
| Explicit, unbiased and probability-weighted estimates of future cash outflows less future cash inflows * | Explicit, unbiased and probability-weighted estimates of future cash outflows less future cash inflows * |
| Discounted using current rates to reflect the time value of money * | Discounted using current rates to reflect the time value of money * |
| Risk adjustment (to adjust for the effects of uncertainty about the amount and timing of future cash flows) * | Composite margin (to remove any profit at inception and released over time) |
| Residual margin (to remove any profit at inception and released over time) | |

*Contract liability measurement*

•*Re-measured subsequent to inception through profit or loss*

*The sum of the first three building blocks in the IASB model (discounted cash flows with risk adjustment) is referred to as the present value of fulfilment cash flows*

# International Financial Reporting Standards (IFRS)

- How will life be different under IFRS?
  - Discount rates—risk free rates
    - This would likely increase liabilities significantly for LTC
    - De-linking the assets and liabilities not consistent with common ALM practices
    - Determination of liquidity premium is very unclear and guidance does not help
    - Volatility introduced with using most current market rates at valuation
  - No lock-in principle—experience flows through P/L
  - Explicit cash flows based on a range of scenarios; can't use factors
  - Transition--current approach does not allow a residual margin for inforce prior to the transition date. This has the impact of reducing future profits
  - Acquisition Costs—different definition than ETIF-09-G, no explicit DAC
  - Margins—US audiences generally do not like the separation between risk and residual margin – the composite margin approach seems more in favor
  - Recognition—financial impact due to changes in assumptions (e.g. discount rate), also concern if loss recognized before effective date
  - Financial Statement Presentation—will you be able to compare companies?