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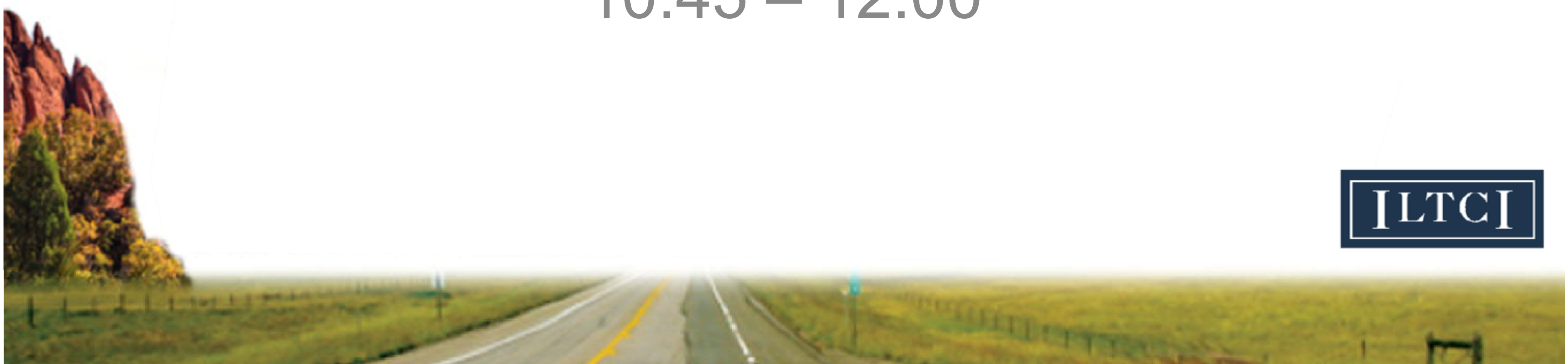
# Financial Reporting

Monday, March 23, 2015

10:45 – 12:00



ILTCI

15th Annual Intercompany Long Term Care Insurance Conference

# Agenda

- Insights and Considerations for Establishing LTC Statutory Liabilities
- FASB Long-Duration Insurance Contracts Project
- Profits Followed by Losses Practice Note

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# LTC Statutory Reserve Valuation Considerations

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*The material in this presentation is general in nature, is not intended to provide specific accounting or tax advice, and is not intended to address any specific company. The information cannot be relied upon and must be validated by the actuary to arrive at his/her own opinion.*

*I hope that you will find my opinions and interpretations of interest. However, this material does **not** represent guidance or established policy of the Arizona Department of Insurance.*

From the VP of Marketing,

***"The LTC products that we've launched during the past years have been great. We far exceeded sales forecasts in each of the last 3 years!"***

Your reaction…

- From the internal report on LTC experience,

***"The persistency on LTC products that we've launched during the past years have been great.  Lapses are far less than forecasts in each of the last 3 years!"***

Your reaction…

# The Long Term Care Marketplace

Positives –

- **Limited competition from other insurers**
- **Reasonably good profit margins (apparently)**
- **Positive cash flow in early years**
- **If things go bad, ability to raise renewal rates (maybe)**

Negatives –

- **Extremely low investment rate**
- **Very long effective duration**
- **The future changes in patient care a big unknown**
- **Mispricing risk HIGH**

In light of those disadvantages, let's consider setting liabilities for the product…

- Reserve Components
  - Active Life
  - Open Claims

- Reserve Components
  - Active Life
    - Unearned premiums
    - Formula reserves (plan factors by issue age, duration)
    - Premium deficiency
    - AAT (Asset Adequacy Testing); stress testing
  - Open Claims
    - Incurred But Not Reported (Estimate of claims not yet reported)
    - Case reserves on reported claims (including waiver of premium)
    - Loss adjudication expenses on above 2 items

- Reserve Adequacy

"In the event a company has a contract or a group of related similar contracts, for which future gross premiums will be restricted by contract, insurance department regulations, or for other reasons, such that the future gross premiums reduced by expenses… will be insufficient to cover future claims, the company shall establish contract reserves for such shortfall in aggregate."

from Health Insurance Reserves Model Regulation, Sec 4, D

- Reserve Adequacy

"…a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. For purposes of determining if a premium deficiency exists, contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured."

from SSAP 54 (Premium Deficiency Reserves)

- Reserve Adequacy (Continued)

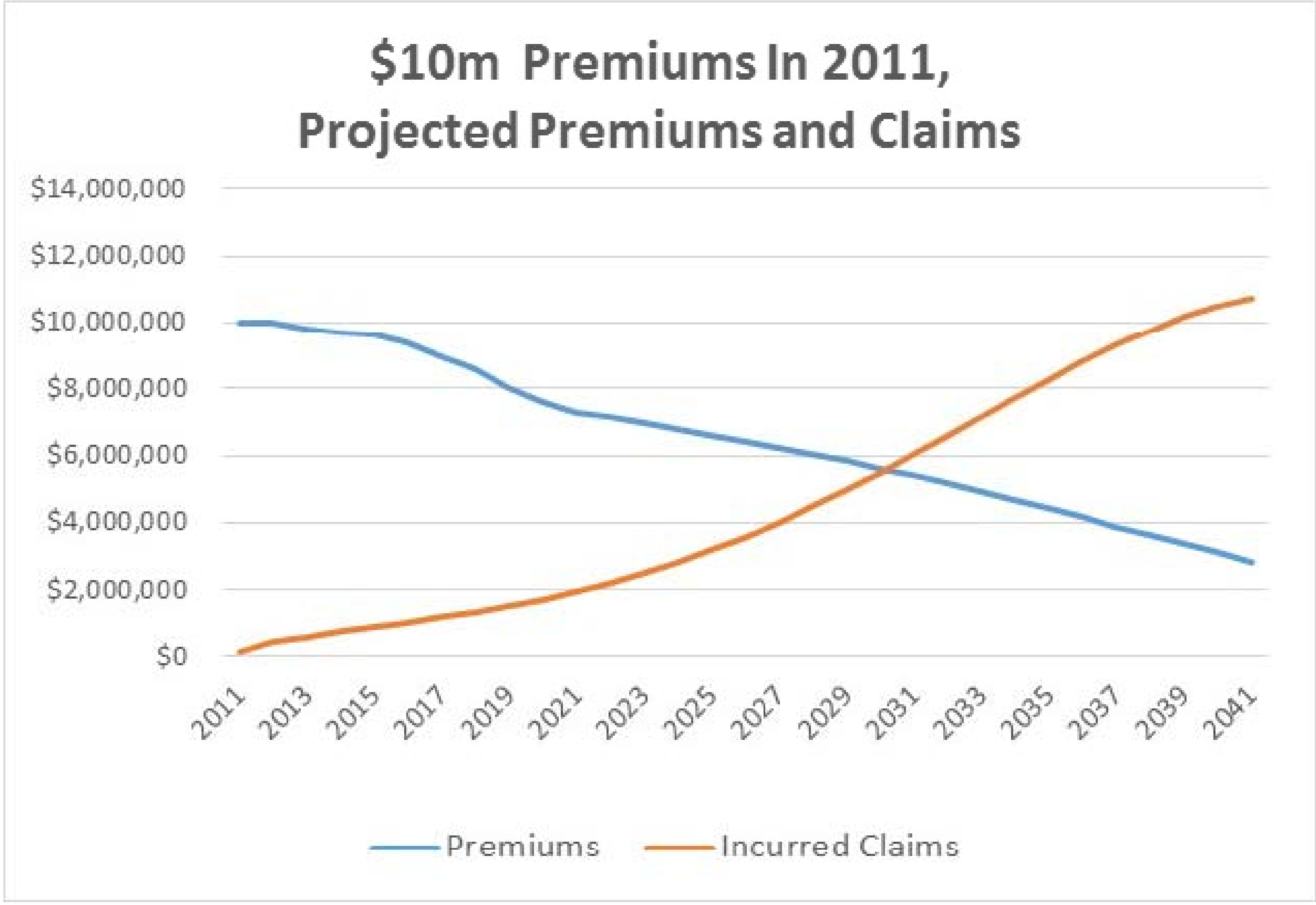
"Cash Flow Testing…, the actuary should consider cash flow testing as a potentially important part of any LTC insurance plan's financial analysis.  This is particularly true if LTC insurance is the sponsoring entity's only product or a major portion of the entity's business."

from ASOP No. 18, Long-Term Care Insurance, 3.6

- Reserve Adequacy (Continued)

"For LTC business, does cash flow testing produce positive results on at least a pop-down 100 bps interest rate scenario? …are the assumed ultimate lapse rates (i.e., for policy years 15 and later) not greater than 1% per year? (If the initial 5-year Treasury rate is less than 4.0%, then one-fourth of the initial 5-year Treasury rate may be used instead of 100 bps.)"

per New York Reg. 56 "Sound Value" Requirement, sited in 10/10/2014 letter from New York State Department of Financial Services


$10m Premiums In 2011,
Projected Premiums and Claims
$14,000,000
$12,000,000
$10,000,000
$8,000,000
$6,000,000
$4,000,000
$2,000,000
$0
2011
2013
2015
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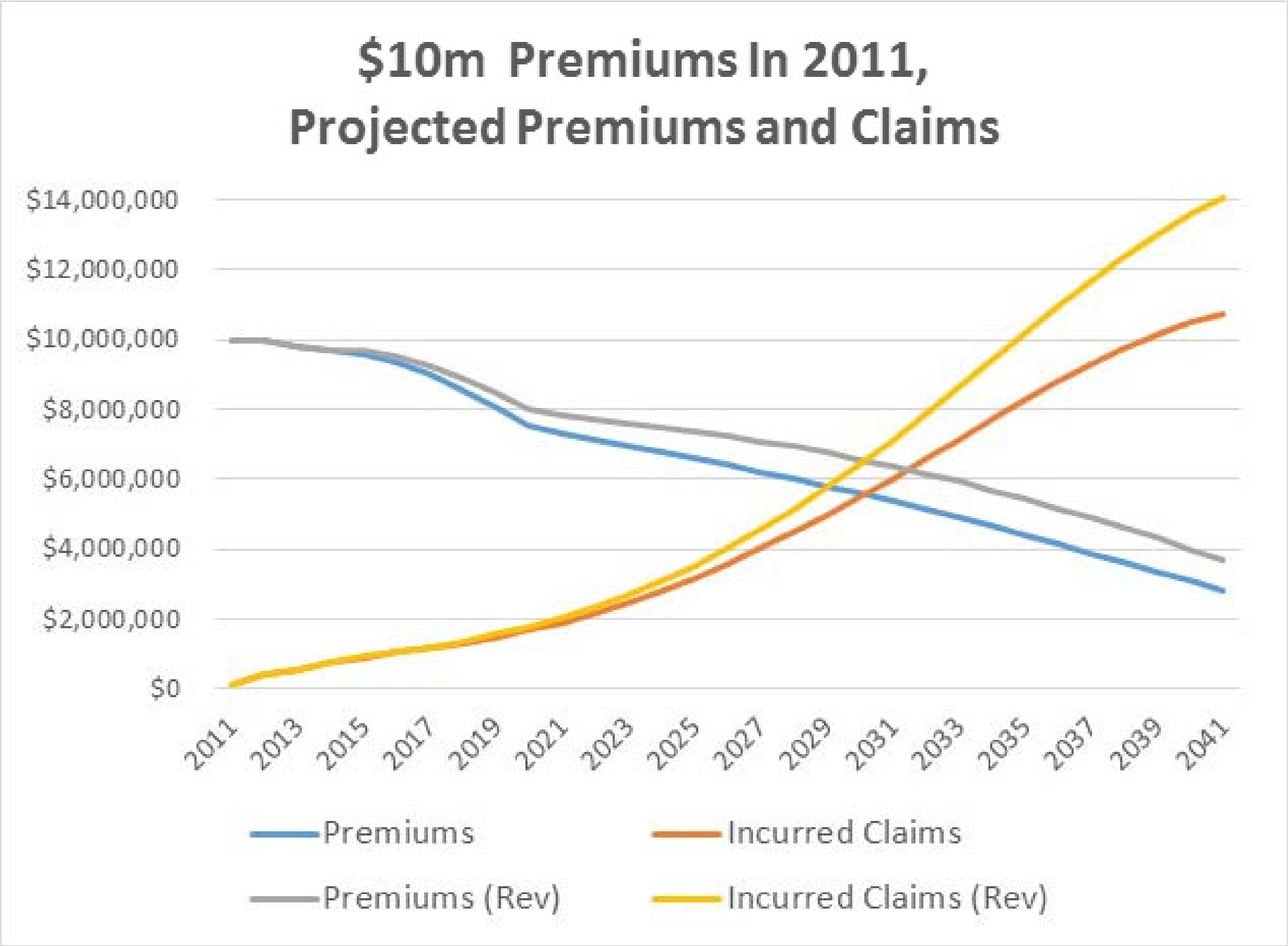
Premiums
Incurred Claims


$10m Premiums In 2011,
Projected Premiums and Claims
$14,000,000
$12,000,000
$10,000,000
$8,000,000
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$4,000,000
$2,000,000
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2011
2013
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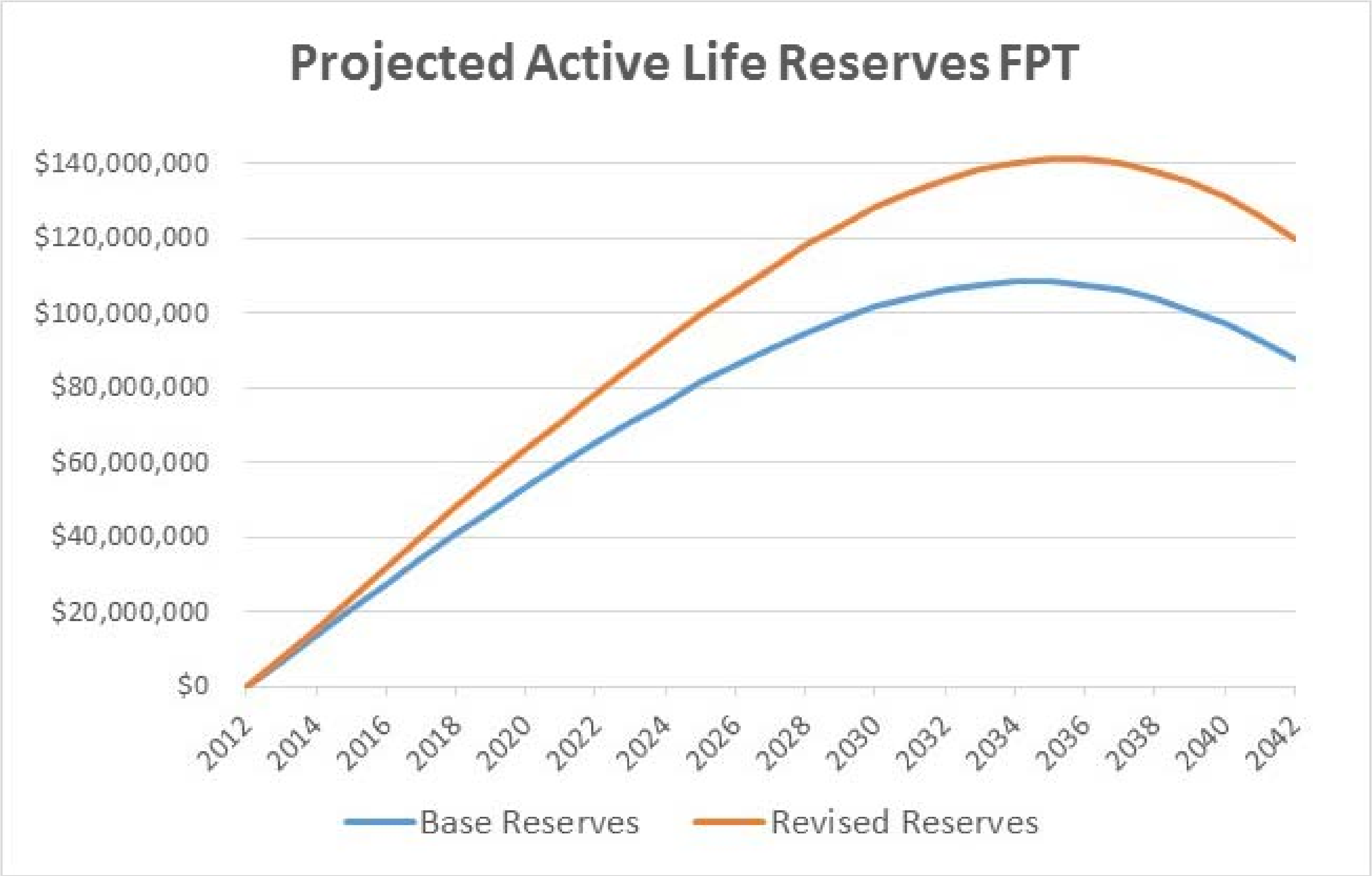
Incurred Claims
Premiums (Rev)
Incurred Claims (Rev)


Projected Active Life Reserves FPT
$140,000,000
$120,000,000
$100,000,000
$80,000,000
$60,000,000
$40,000,000
$20,000,000
$0
2012
2014
2016
2018
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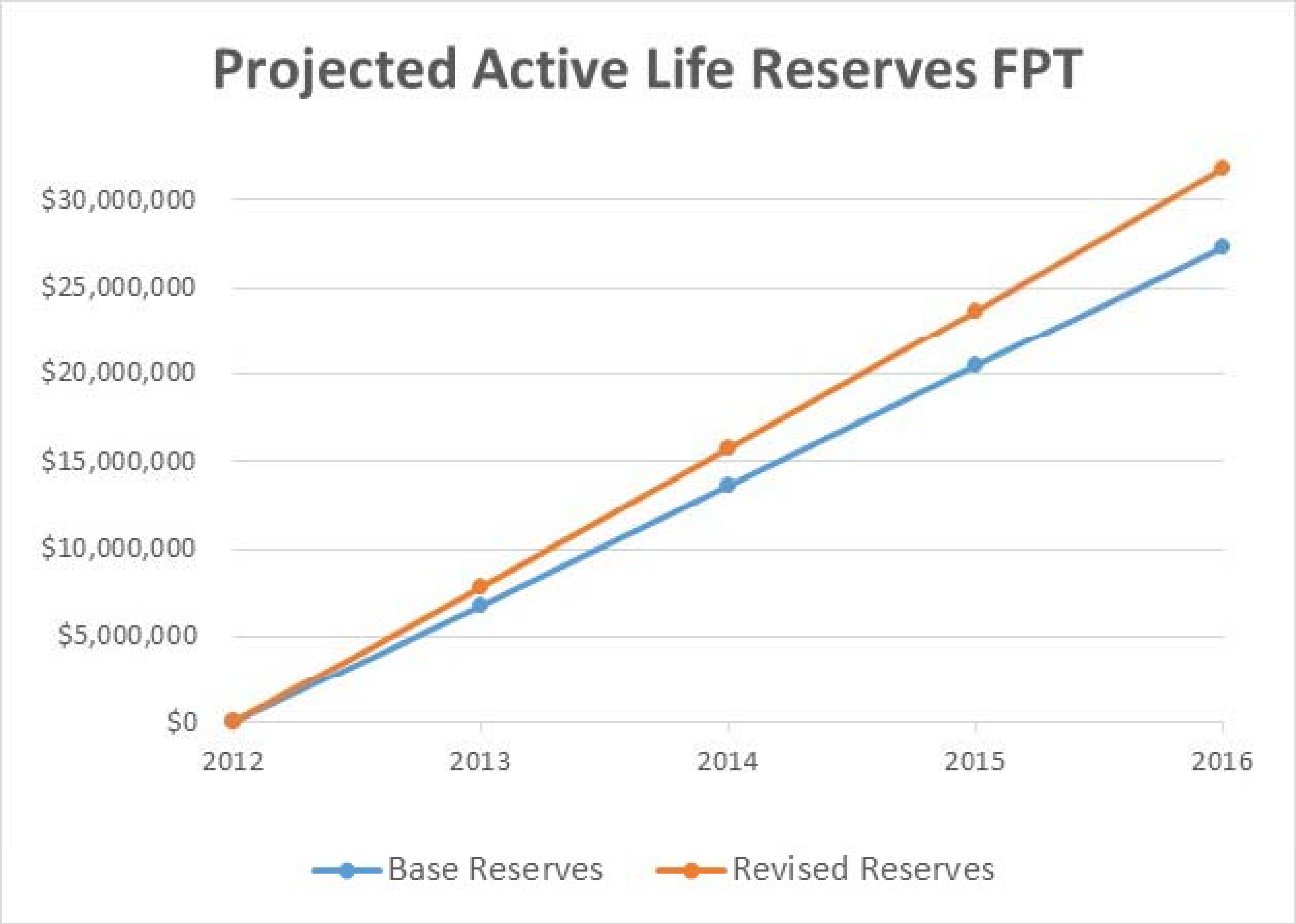
2042
Base Reserves
Revised Reserves


Projected Active Life Reserves FPT
$30,000,000
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
2012
2013
2014
2015
2016
Base Reserves
Revised Reserves

- Past LTC Rate Increases
  - Can we assume past success on pre-stabilization rate approvals is indicative of forecasted rate approvals for purposes of reserve testing?

- Reserve Adequacy Considers Rate Actions New York's View.

  For meeting Sound Value requirements,

  "Asset adequacy analysis should anticipate no premium rate increases unless they have been approved and implemented."

  per New York Reg. 56 "Sound Value" Requirement, sited in 10/10/2014 letter from New York State Department of Financial Services

- Reserve Adequacy Considers Rate Actions

“When accounting for future premium increases, the actuary [should consider]…company’s history of rate increases, the rate increase amount that is likely to be approved by regulators, and management intent to file for these rate increases.

When considering the filed rate increase amount, the actuary should recognize that the full filed amount may not be approved and that an appropriate assumption should be determined.”

From Practices for Preparing Health Contract Reserves, September 2010 AAA Practice Note

Active Lives Disabled Lives

When a policy is in Claims status, it is not also in Active status so generally would not be included in active life reserves as well disabled life reserves. Nevertheless, some policies in claims status will again become active, which will again make them eligible for a future claim. Those in one claims status could also become eligible for a richer benefit claims status.

# What Will Happen (ultimately) to Policies in Claims Status?

1. Testing of past claims reserves
2. Schedule H test (should also consider product by product)
3. Are there adverse trends in claims severity?
4. Where is the claims margin and does it cover adverse assumptions under claims severity?

# FASB Long-Duration Insurance Contracts Project

Laurel Kastrup, FSA, MAAA
Managing Director, KPMG
2015 ILTCI

ILTCI

# Note

- This presentation is a discussion of industry perspectives and observations.  Summaries are not intended to replace accounting literature. Views and opinions are not intended to represent the position of KPMG LLP or to provide accounting advice.

# Background

- FASB had determined that improvements in US GAAP were needed
- 2008: FASB joined the IASB's Insurance Contract project
- During 2014: FASB decided to cease joint deliberations of the Insurance Contract project with IASB
  - Limit the scope to insurance companies
  - Split project into long-duration and short-duration phases

# Potential Targeted Improvement #1

- Liability for future policy benefits
  - Periodic assumption updates
  - Guidance for discount rate
  - Disclosures about methods & assumptions
  - Measurement of options and guarantees that are not derivatives

  Board additions:
  - Need for provisions for adverse deviation?
  - Nature of cash flows included
  - Unit of account

# Assumptions--Currently

- Periodic assumption updates
  - Currently for LTC assumptions used for future policy benefit liabilities are established with a provision for adverse deviation (PAD) and locked in at policy inception
    - Only unlock if premium deficiency
    - Discount rate, mortality, morbidity, lapse, expense

# Assumptions—Board Decision

- Board decision:
  - Update all assumptions annually in the 4th quarter
  - Disclose
  - No provision for adverse deviation
  - Recognize the effects of changing assumptions in net income

# Assumptions—Future

- How should the effect of changes in assumptions on contract liabilities be accounted for?
  - Prospective or retrospective unlocking?
  - Net premium ratio unlocked or locked?
    - – Unlocked and uncapped?
    - – Unlocked and capped at 100%?
      - » Does capping the net premium ratio mean you need a premium deficiency test?

# Assumptions—Board Decision

- Disaggregated Disclosures
  - Balances of the liability for future policy benefits & weighted-average discount rates used in time bands
  - Qualitative & quantitative information about methods & inputs used
    - » Assumptions used(discount rate, mortality, morbidity, termination, lapse, expense)
  - Reconciliations from opening to closing balance of the liability
    - » Separate for changes in liability due to new contracts, benefit payments, changes in assumptions, and derecognition of contracts

Decision on additional disclosures in interim periods deferred to future meeting

# Discount Rates

- Current GAAP
  - Asset-based rate
    - LTC uses expected investment yield
- Board Decision
  - Discount rate determined using a reference portfolio of high-quality, fixed income investments
  - Consistent with approach used in measuring pension liabilities

Staff working on proposed disclosures and if guidance is needed for the term “high quality”

# Potential Targeted Improvement #2

- Deferred acquisition costs (DAC)
  - Manner in which to amortize DAC
    - Retrospective vs. prospective
  - Is retrospective unlocking required?
    - Disclosure on determination and future effects?
  - Disclosure of DAC rollforward
- Premium deficiency and loss recognition
- Disclosures about revenue recognition

# DAC Amortization--Currently

- DAC Amortization method depends on type of contract
  - Traditional long duration
    - In proportion to expected premium
  - Universal Life and investment contracts
    - Constant rate applied to the present value of gross profits expected to be realized over the life of the contract
  - Participating contracts
    - Constant rate applied to the present value of gross margins expected to be realized over the life of the contract

# DAC Amortization—Board Decision

- Apply a consistent method across all types of long duration insurance contracts
- Amortize over the expected life of a book of contracts in proportion to the balance of the insurance inforce
  - If amount of insurance inforce is variable of cannot be determined, amortize in proportion to the number of contracts outstanding
  - Expected life considers morbidity, mortality, and terminations
  - Interest does not accrue on the undiscounted balance

# DAC Amortization—Future

- Should effect of changes in assumptions on DAC amortization be accounted for on a retrospective or prospective basis?

# Potential Targeted Improvement #3

- Premium deficiency and loss recognition
  - Level of aggregation
  - Disclosures
    - Loss recognition margin
    - Level of aggregation
    - Significant assumptions
    - Amount recorded

Based upon the decision to update all assumptions annually, FASB decided to eliminate the premium deficiency test

# Potential Targeted Improvement #4

- Disclosures about revenue recognition
  - Premiums earned vs. premium due model
  - Timing of recognition for premium earned model

Board decided against deliberation on revenue recognition, but will consider the need for additional disclosures

# Timing

- FASB expects to have tentative decisions during 2015
- Future exposure draft?

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# Profits Followed by Losses Practice Note


Laurel Kastrup, FSA, MAAA

Managing Director, KPMG


2015 ILTCI

ILTCI

# Practice Note

- AAA issued an Exposure Draft on “GAAP Accounting for Profits Followed by Losses in Long Duration Contracts” in October 2014
- Expect practice note to be finalized soon

# What are profits followed by losses?

- Originally in FAS 60, paragraph 37
- Now ASC 944-60-25-9
- *"A premium deficiency, at a minimum, shall be recognized if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset losses that would be recognized in later years."*

# How do you define losses?

- Requires GAAP net income projection for the life of the contract
- May not need overhead expenses

## Under what circumstances do profits followed by losses occur?

- Depends on pricing, contract provisions, and changes to estimates
- LTC
  - Rate increases that are not reflected in locked-in Active Life Reserves
  - Policyholders incur claims later than expected

# At what level should the test be performed?

- Accounting guidance does not specifically state
- Similar to premium deficiency
  - Acquiring
  - Servicing
  - Measuring

# Should future rate increases be considered?

- No specific accounting guidance
- Generally comparable assumptions to premium deficiency testing
  - Future rate increases are generally considered in premium deficiency and loss recognition
- Consider:
  - Historical and projected experience
  - Management decisions
  - Likelihood and amount of regulatory approval
  - Experience on past rate increases
  - Environment

# What happens when the test shows profits followed by losses?

- ACS 944-60-25-9
  - *“the liability shall be increased by an amount necessary to offset losses that would be recognized in later years.”*

## How should the liability be increased?

- No accounting guidance
- Section 9.94 of the AICPA *Audit and Accounting Guide for Life and Health Insurance Entities* (2013) discusses profits followed by losses situations and states: "Adjustments should always be made when losses first become apparent."
  - Does not indicate "how" but "when"

## What are some methods that could be considered for increasing the liability for future losses?

- Immediate increase to offset all losses
- Locked-in schedule to increase over time to offset all losses
- Dynamic increase schedule to increase that changes over time as projections of losses change
- Combination of methods

Overriding consideration for many is the accounting model applied to the contracts

# What are some considerations around establishing an immediate increase in liabilities?

- Immediate increase to offset all losses results in a current period loss
  - Contradicts ASC 944-60-35-5:
    - "(n)o loss shall be reported currently if it results in creating future income."

## What are some considerations around accruing an increase in liabilities over time?

- Pattern of accrual
- Time period over which to accrue
- Two common approaches:
  - liability that is just adequate to offset future losses at such time as the future losses are expected to commence
  - just enough liability to prevent a loss recognition event from occurring at the earliest point at which it is expected to occur the future.

## What are some considerations around adopting a locked-in schedule to establish an additional liability over time?

- May adjust for difference between actual and expected inforce
- May be recommended approach for FAS 60 as it is consistent with lock-in
- Actual experience may not match assumptions so liability may be to high or may need multiple layers

## Once a reserve has been accumulated to cover future losses, how should the additional liability be released into income?

- No explicit guidance
- Might make sense to follow same method—locked –in vs. dynamic as accrual

# Locked-in release method

- Release pattern to match projected losses
- May not match actual losses as experience differs from expected
- May reconcile reserve amounts to inforce
- Consistent with locked-in reserve for FAS 60 products

# Profits followed by losses followed by profits

- No explicit guidance
- Different approaches
  - Reserves established from early year profits to cover losses
  - Only accrue liability when aggregate present value of profits is negative

## Shadow accounting

- Need to consider if “shadow” adjustments are needed
- Record, as an adjustment to surplus through other comprehensive income, the impact on any items that would change were assets immediately sold that are carried as available for sale
- Adjustment could be required were the liquidation of such assets to cause a change in the establishment or release of reserves

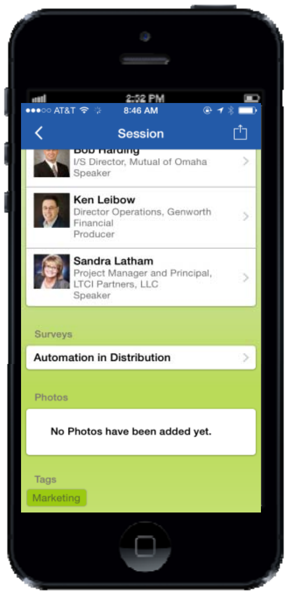
Questions?

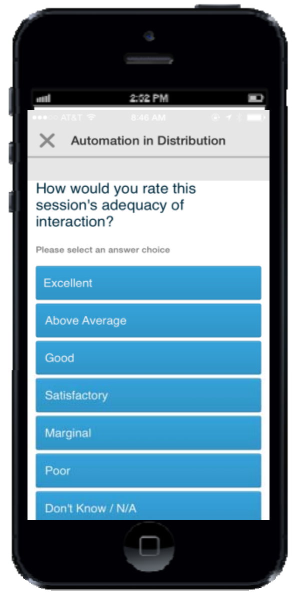
# Don’t forget to fill out the survey

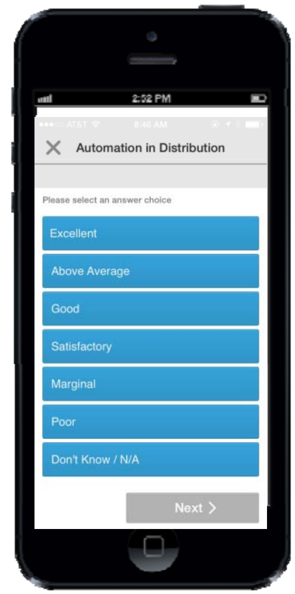
1st you must have download the ILTCI Mobile App
- Go to your app store; search ILTCI.  It’s free.

ANDROID APP ON Google play

Available on the App Store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