

Session 17: US GAAP – Emerging Issues

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SOCIETY OF ACTUARIES

Agenda

- Forces for Change
- Current International Developments
- Current or Emerging US GAAP Issues



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Forces for Change



Forces for Change

1. Unfinished Business
2. From within the Industry
3. Convergence Activities
4. International Insurance Regulators
5. Capital Markets and Technology
6. Globalization and Financial Service Convergence
7. Need for Better Information



Unfinished Business

- Fair value
 - The FASB has stated its long term accounting objective is fair value
 - Its FV measurement guidance is currently in Concept 7, low in FASB accounting hierarchy
- Financial guarantee insurance contracts
- Finite reinsurance



From within the Industry

- New products
 - Life settlements
 - Variable annuity benefits
 - e.g., Guaranteed Minimum Withdrawal Benefits
- Reinsurance
 - Primarily resulting from financial and finite reinsurance, mostly P&C driven due to lack of discounting of loss reserves
 - Risk transfer issues



Convergence Activities

- The FASB and the IASB
 - Norwalk agreement (9/2002) – the commitment
 - Memorandum of Understanding (1/2006) – the roadmap, a 3 year plan
 - Short-term convergence and joint projects
- Others
 - Joint work plan between the SEC and the Committee of European Securities Regulators (8/2006)
 - Each to review implementation of IFRS and US GAAP, respectively for each of their registrants
 - Canada, Japan and China
- Principles-based rather than rules-based
- The goal: a single global set of high quality, transparent accounting standards useful for economic decision making
 - The reality: gradual progress through mutual cooperation



International Insurance Regulators

The International Association of Insurance Supervisors (IAIS)

- Their stated goal is to have a common set of liabilities for regulatory and general purpose use
- Although overall in agreement, there are currently key differences with the IASB
- Uncertain as to effect on U.S. regulatory system
 - Move to principle-based reserving may serve as a starting point for convergence



Capital Markets and Technology

- Increased emphasis on economic and prospective values
- Enhanced modeling capabilities make responsive values and reporting more practical
 - Need for judgment remains
- Technologies such as HTML facilitates easier public access to information



Globalization and Financial Service Convergence

- IASB and IAIS positions suddenly of concern to the U.S.
- Mutual recognition of multiple listing in difference stock exchanges
- Greater dominance of multi-national firms in many local markets
- Demands for consistent reporting of similar economic values across industry



Need for Better Information

- Ever-increasing demand for more disclosure
 - Everyone wants to see more reinsurance information
 - SEC in MD&A
 - IASB
 - In Phase 1, size of financial statements often doubled
 - In new IFRS 7, eliminated policy descriptions, but enhanced sensitivity and other requirements
 - IAIS disclosure standards/proposals go well beyond current regulatory requirements



Current International Developments



Current International Developments

1. IASB Phase 2 Time Table (ESTIMATED)
2. Other relevant IASB projects
3. IASB Discussion Paper Highlights
4. IAIS First Liabilities Paper
5. CEOIOPS (Solvency II)



IASB Insurance Contracts Phase 2 – Timetable

- | | |
|-------------------------|-------------|
| • IAA Exposure Draft | Out now |
| • IASB Discussion Paper | Out now |
| • IASB Exposure draft | End of 2008 |
| • Final standard | 2010 |
| • Effective | 2012 |



Other relevant IASB projects (1)

1. Joint Conceptual Framework project
 - Long-term, but crucial if significant change
2. Revenue Recognition
 - Not likely to be gross receipts
 - Difficult – search for common principles for all industries
3. Business Combinations
 - Joint exposure draft being discussed that few liked (I will be discussed in US GAAP section)
4. Liabilities and Equity
 - Will attempt to distinguish these
 - Important for participating contracts



Other relevant IASB projects (2)

5. Financial Instruments re-look
 - Implications of mixed attribute system vs. fair value
 - De-recognition, hedge accounting
 - Huge amount of minor issues that could be addressed
 - Opting for major review later
6. Performance Reporting
 - Consolidated income? Recycling, ...



IASB Discussion Paper

Selected Sections:

1. Overview and timetable
2. Scope
3. Building blocks of the IASB current exit value
4. Comparison with industry groups' proposals



Overview and Timetable

- This is “Phase II” of IASB insurance project
- “Phase I” resulted in IFRS 4, *Insurance Contracts*, an interim standard that permits a wide variety of accounting principles
- Accounting models currently in use internationally under IFRS 4 include:
 - Local GAAP
 - Or, typically US GAAP if multi-national company
- Not yet an official IASB/FASB joint project
- But FASB has recently issued the discussion paper in US for comment
- FASB will use responses to decide whether to pursue joint project with IASB to develop a global standard on accounting for insurance contracts



Overview and Timetable

- Discussion paper is result of nearly three years of IASB Phase II work
- IASB discussed extensively with industry via Insurance Working Group
- Industry groups (CFOF and GNAIE) and regulators (IAIS) published their preferences in 2006
- Comment period of 6 months ends on 16 Nov. 2007
- IASB expects the exposure draft to be out by the end of 2008
- IFRS could be published by 2010 if overall timetable met
- Expected to be effective 2012???



Scope

- Insurance and reinsurance contracts issued by insurers*
- Insurance contracts ceded by insurers*
 - "Insurer" is defined in IFRS 4 as any entity that issues insurance contracts (irrespective of whether or not the issuer is regarded as an insurer for legal or supervisory purposes)
- Some aspects of participating investment contracts
- Paper does not address accounting by policyholders
 - But final standard also is expected to
- Paper does not include non-participating investment contracts
 - Inconsistencies exist between proposal and IAS 39
 - Board considering whether to eliminate inconsistencies



Building blocks of the IASB current exit value

- Single approach for all insurance contracts, life and non-life
- Three building blocks:
 - Current market-consistent probability weighted estimates of contractual cash flows
 - Current market discount rates to adjust estimated cash flows for time value of money
 - Market consistent margins (for bearing risk and if applicable, rendering services)
- Result of above is “current exit value” → hypothetical transfer to a third party



Building blocks of the IASB current exit value

- Exit value model:
 - Could result in immediate gain or loss
 - Transaction price useful as reasonableness check for exit value amounts, but not determinative of exit value
 - No deposit floor (unlike IAS 39)
 - Acquisition costs are expensed as incurred
- Alternative current entry value approach
 - Initial measurement calibrated to transaction price (premium)
 - Subject to liability adequacy test (day 1 loss possible)
 - Risk “price” is fixed but “quantity” of risk is current



1st Exit Value Building Block

- Estimates of contractual cash flows should be:
 - Explicit
 - Market consistent
 - Probability weighted
 - Unbiased
 - Current



1st Exit Value Building Block

- Determining expected present value:
 - Identify each possible scenario
 - PV cash flows in that scenario
 - Make unbiased estimate of probability of that scenario
 - Insurer might develop estimates of each scenario by:
 - identifying individual scenarios
 - developing a formula that reflects insurer estimate of shape and width of probability distribution, or
 - by random simulation



1st Exit Value Building Block

- Market-consistent vs entity specific cash flows:
 - Should not capture cash flows due to synergies between insurance liability and other assets or liabilities
 - But should capture specifics of portfolio being measured
 - For unobserved variables (e.g., frequency/severity of claims, mortality), rarely persuasive evidence that insurer's own estimates differ from estimates other market participants would make



1st Exit Value Building Block

- Reflect market participant (not entity specific) efficiency
 - Use servicing costs that market participants would incur
 - Don't use entity specific servicing costs that reflect synergies others don't have
 - Don't use costs reflecting inefficient servicing system (e.g., antiquated claims administration system)
- But reflect characteristics of contract; strategy for handling
 - Level and type of service provided
 - Approach to claims management



2nd Exit Value Building Block

- Discount rates
 - Consistent with observable current market prices
 - For cash flows whose cash flows match those of insurance liability in terms of:
 - Duration
 - Liquidity
 - Currency
 - Discount all liabilities (long and short duration)



3rd Exit Value Building Block

- Risk Margin
 - Explicit and unbiased estimate of margin that market participants require as compensation for bearing risk
 - Reflects uncertainty in timing and amount of estimated future cash flows
 - not a “cushion”
 - What a third party would require to assume risk
 - Not calibrated to premium
 - But premiums provide reasonableness check



3rd Exit Value Building Block

- Risk margin is portfolio rather than entity specific, reflecting pooling of liabilities
 - But not diversification across portfolios or negative correlation that different portfolios could provide
- No specific method prescribed; example approaches provided
 - Confidence level, CTE, TVaR, Cost of Capital



3rd Exit Value Building Block

- Characteristics of the risk margin will likely include the following:
 - The less that is known about the current estimate and its trend, the higher the risk margin
 - Risks with low frequency and high severity will have higher risk margins than risks with high frequency and low severity
 - For similar risks, long duration contracts will have higher risk margins than those of shorter duration
 - Risks with a wide probability of distribution will have higher risk margins than those risks with a narrower distribution
 - To the extent that emerging experience reduces uncertainty, risk margins will decrease, and vice versa



3rd Exit Value Building Block

- Service Margin
 - Market consistent margins for rendering services
 - E.g., investment management services
 - Unit-linked and variable contracts, universal life
 - Income (loss) recognition on Day 1 if insurer receives fee higher (lower) than market participants would demand
 - Differs from current revenue recognition under IAS 18 based on stage of completion



Building blocks of the IASB current exit value

- IASB rationale for current exit value:
 - More faithful representation of insurer obligations and rights
 - Conveys more useful information about amounts, timing, uncertainty of cash flows
 - Current estimates and use of explicit rather than implicit require insurer to actively consider whether circumstances have changed
 - Explicit rather than implicit risk margin
 - avoids need for separate liability adequacy test
 - more coherent framework for complex contracts such as multi-year, multi-line, or stop loss contracts, avoiding need for arbitrary rules



Building blocks of the IASB current exit value

- IASB rationale for current exit value (cont):
 - eliminates need to separate embeddeds
 - consistent with IAS 37 and IAS 39 which require current estimates of future cash flows
 - reduces motivation to use reinsurance to recognize previously unrecognized gains
 - No need for arbitrary criteria to distinguish amendments to existing contracts from new contracts
 - reduces possible accounting mismatches between assets and liabilities



Building blocks of the IASB current exit value

Opponents of exit value approach:

- Exit value places too much reliance on hypothetical transactions that rarely occur (i.e. transfers)
- Entry value reflects real transaction – price charged to PH
- No conceptual basis for Day 1 gains
- Market-consistent cash flow assumptions and market-consistent risk margins are not observable or attainable; introduces more subjectivity and non-comparability into the estimates
- Some believe discounting of non-life liabilities is not appropriate due to unpredictable nature of cash flows
- Current exit value inappropriately implies a greater measure of precision in the estimate that just isn't there



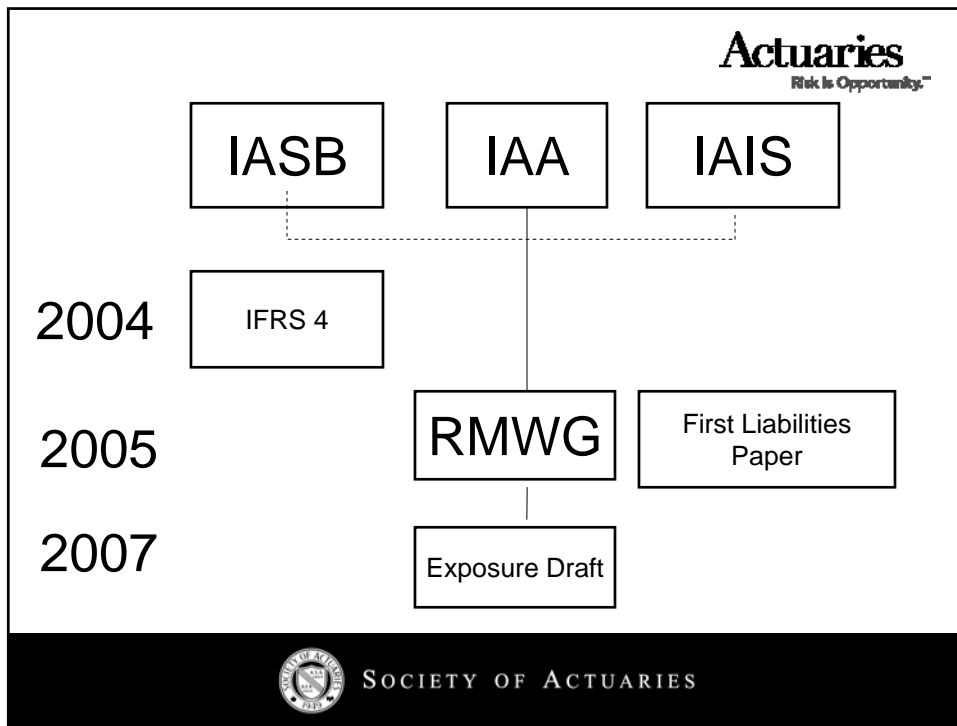
Comparison with industry groups' proposals

- Industry contributions to the debate: European CFO Forum and Group of North American Insurance Enterprises (GNAIE)
- Key issues raised concerning IASB proposals:
 - GNAIE preference for two models
 - Life: discounted
 - Non-life: no discounting
 - CFO Forum preference for separate pre-claim's margin (implicitly calculated at entry) and post-claim's margin for uncertainty in claim liability
 - CFO Forum and GNAIE preference for
 - Prohibition of day 1 gains
 - No separate service margin
 - No impact of credit standing after initial valuation
 - Participating contracts measured using best estimate of policyholder benefits
- Reliability and relevance



IAA Risk Margin Working Group






Actuaries
Risk Is Opportunity.™

IAIS Objective

- Financial Reporting vs. Regulatory Liabilities
 - Differences “reconcilable or easily explained”
- “Total Balance Sheet” approach –
 - Capital absorbs risk

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Insurance Liabilities

Current (“Best”) Estimate

+

Risk Margin



Current Estimate

- All relevant cash flows (benefits, expenses, etc.)
- Based upon observed prices (if available)
- Portfolio specific
- Consistent assumptions
- Use less desirable sources if data inadequate
- Probability weighted



Reference Entity

Assumptions - basis

- Financial Assumptions – market
- Actuarial Assumptions (lapse, etc) – portfolio
- Expenses – Reference Entity

Reference Entity

- Potential Acquirer
- Large enough to minimize operational risk



Risk Margin - Purpose

IASB

IAIS

Risk Compensation

Provision for
Uncertainty



Risk Margin Methodologies

- Explicit assumptions
- Cost of Capital (CoC)
- Percentile (VaR)
- Conditional Tale Expectation (CTE)
- +



Explicit Assumptions

- Canadian precedent
- Examples
 - Mortality 0.003 \Rightarrow 0.0033
 - Interest 5.0% \Rightarrow 4.5%
 - Lapse 20% \Rightarrow 25% or 15% (lapse support)
 - Expense \$HK 20 \Rightarrow \$HK 22



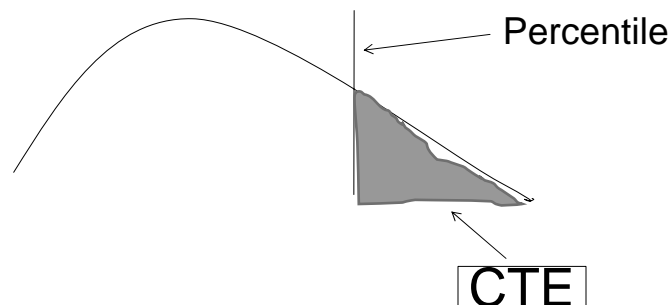
Cost of Capital (CoC)

- Included as a Cash Flow
- $CoC_t = k * C_t$
 - Required Capital (year t) = C_t
 - k = net cost rate = $I - (1-T)*IA$
 - I = required return
 - T = tax rate
 - IA = asset yield



Conditional Tail Expectation

- Probability Distribution



Practical Approaches

- Not addressed in detail
- Informal discussions
 - Simplified approaches
 - Standard Models
 - Roll forwards



Current or Emerging US GAAP Issues



Current or Emerging US GAAP Issues

1. FAS 157 – Fair Value Measurement
2. Fair Value Option
3. Principle-Based Reserving
4. Business Combinations SFAS 141R
5. Financial Guarantee Contracts



Fair Value Measurement – SFAS 157

- Final version released in September 2006
- Effective for years beginning after November 15, 2007
- Indicates how to fair value, not what to fair value
- Upgrades current Concept 7
- Introduces several new concepts
 - Three input levels
 1. market prices
 2. market derived
 3. non-market derived
 - Mark to model, not using anything that market participants would not use
 - Limited specific guidance expected to be provided
 - Distinction
 - Disclosure-related, as level 3 requires disclosure of methods, assumptions, ...
 - Originally day one profits were not going to be allowed for level 3
 - Principal market (or most advantageous if no principal market)
 - Uses view of reporting entity



Fair Value Option – Phase 1

- SFAS 159 is the first of two expected phases
- Permits, based on a one-time irrevocable election, the option of measuring a financial asset or liability at fair value
- Final version released in February 2007
- Effective for years beginning after November 15, 2007
- Permits enhanced asset/liability matching
- Comparable to IASB option



Fair Value Option – Phase 2

Phase 1 Financial Assets and Liabilities excludes:

- An investment (principally an investment in a subsidiary) that would otherwise be consolidated.
- An interest in a variable interest entity that is consolidated
- Pension plan and employee compensation
- FASB Statement No. 13, Accounting for Leases financial liabilities
- Financial liabilities for demand deposit accounts
- Financial instruments that are in whole or in part classified by the issuer as equity (including temporary equity)



Principle-Based Reserving

- No direct link to GAAP values
- However, its implementation at the same time or prior to IASB Insurance Contracts Phase 2 could facilitate implementation by U.S. insurers
 - Particularly its rigorous assumption validation process could help enhance similar development of GAAP assumptions.



Business Combinations SFAS 141R

- FAS 141(R) still being discussed by FASB
 - Companion document is revision of IFRS 3 on Business Combinations
 - Also accompanied by significant changes in focus of reporting of equity
- Changes expected to be effective 1/1/2009
 - Delay is to accommodate constituent digestion of international standards



Implications of Changes to SFAS 141R

- Many well-established business combination accounting practices will change
- Will significantly affect how acquisition and disposition transactions are reflected in the financial statements
- Business models will need to be revised
- Management will need to understand the financial and business implications posed by the proposals



SFAS 141R

<u>Key Provision</u>	<u>Current GAAP</u>	<u>Proposed Rules</u>	<u>Implication</u>
<i>Contingent assets and liabilities recognized at fair value</i>	Generally record when "probable and reasonably estimable"	Record all contingent assets / liabilities at fair value on acquisition date; subsequently adjust to fair value through earnings	As fair value of contingency changes, the difference flows through earnings each period; difficulty in measuring the fair value of contingencies
<i>Contingent consideration</i>	Generally record when issued / settled	Record at fair value on acquisition date; subsequently adjust to fair value through earnings	Similar to acquired contingent assets and liabilities – volatility in the income statement, possible counter-intuitive accounting



SFAS 141R

<u>Key Provision</u>	<u>Current GAAP</u>	<u>Proposed Rules</u>	<u>Implication</u>
<i>Definition of a business</i>	A self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors.	An integrated set of activities and assets <u>capable of being</u> managed and conducted for the provision of a return to investors and other benefits to owners.	Will reduce the number transactions that will be considered assets purchases and increase the number of transactions that are deemed business acquisitions.
<i>Restructuring costs expensed</i>	Record restructuring costs of the acquired business as part of the purchase price	Charge restructuring costs to earnings in post-acquisition income statements	Less goodwill; non-recurring charges to earnings over several periods as new business is integrated



SFAS 141R

<u>Key Provision</u>	<u>Current GAAP</u>	<u>Proposed Rules</u>	<u>Implication</u>
<i>Measurement date changed to closing date</i>	Agreement date used to value securities	Value securities on closing date.	Recorded acquisition price could change significantly (up or down) from agreement date, affecting amount of goodwill recorded (or possibly negative goodwill)
<i>Acquisition costs expensed</i>	Capitalize external acquisitions costs – historical-cost concept	Expense all acquisition costs as incurred	Less goodwill, more non-recurring charges in earnings



Financial Guarantee Contracts

- FSP No. FTB 85-4-1
 - Accounting for Life Settlement Contracts by Third-Party Investors
 - The next phase of viatical contracts
 - The insurer can choose between accounting measurement by either the investment method or the fair value method, with the choice irrevocable (on an instrument by instrument basis)



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